

# Compensating defrauded shareholders in insolvency: is parity the answer?

BLANCA MAMUTSE\*

*University of Surrey*

## *Abstract*

*This paper studies recent developments in Australian and US law permitting compensation for defrauded investors. For insolvent companies, these developments have drawn attention to the possibility of investor claims being satisfied on parity with the claims of ordinary unsecured creditors. This paper proposes that such a shift may be justified on the basis of a modern perspective of the principles underpinning corporate law. However, account must also be taken of the more practical implications which may hinder a widespread acceptance of parity.*

## Introduction

A notable development in the field of investor protection law over the past few years has been the extension of the concept of rateable (or *pari passu*) distribution within the class of ordinary unsecured creditors to accommodate the interests of defrauded shareholders.<sup>1</sup> This is due to the phenomenon of shareholder claims, defined as claims for damages against a company by a subscriber for or purchaser of its shares, where the claimant relies upon misleading or deceptive conduct of the company, or other wrongful acts or omissions on its part as being causative of his or her loss.<sup>2</sup> At first glance, it would seem that such an approach is contrary to the rule that debts owed to a member of a company in his or her capacity as such (*qua* member) may not be satisfied before the claims of other creditors have been met.<sup>3</sup> This enforces the principle that:

. . . the rights of members *as members* come last, i.e. rights founded on the statutory contract are, as the price of limited liability, subordinated to the rights

---

\* Lecturer in Law, University of Surrey, UK. I am grateful to my colleague Alison Clarke for her insightful comments on an earlier draft of this paper. A condensed version of this paper was presented at the Society of Legal Scholars' annual conference in September 2011: I am indebted to the participants of the subject session for their helpful suggestions. I take responsibility for any errors.

1 See landmark decision of Australia's highest court in *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1; and changes brought about in US by Sarbanes–Oxley Act – both discussed below. The *Gwalia* judgment has led Australian Federal Government to introduce new legislation, also discussed below.

2 *Sons of Gwalia* [2007] HCA 1, para. 34.

3 See, for example, s. 74(2)(f) of the UK Insolvency Act 1986. See, however, s. 655 Companies Act 2006 – a shareholder's claim against the company for damages or other compensation is not barred by mere fact of his or her ownership of (or entitlement to) shares in the company.

of creditors based on other legal causes of action. The rationale . . . is to ensure that the rights of members as such do not compete with the rights of the general body of creditors.<sup>4</sup>

In English law, this signals a distinction which is made in upholding shareholder claims, between sums claimed *qua* member arising from the statutory contract, and claims in respect of which membership is an essential qualification for acquiring the claim but not the foundation of the cause of action.<sup>5</sup> On the other hand, the approaches recently adopted in the US and in Australia drive us to review the justifications for the established rule in the light of modern perspectives of corporate relationships. It is a matter of interest to lawyers in other jurisdictions, as the financial downturn has resulted in claims for securities loss being pursued against companies in foreign courts, particularly in the US.<sup>6</sup> These developments also provide an important insight into the intersection between the insolvency distribution rules and market regulation. These underlying questions, and the connection between them, are helpfully condensed in this extract from the decision of the High Court of Australia in the matter of *Sons of Gwalia Ltd v Margaretic*:

[M]odern legislation . . . has extended greatly the scope for “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. Corporate regulation has become more intensive, and legislatures have imposed on companies and their officers obligations, breach of which may sound in damages, for the protection of members of the public who deal in shares and other securities. 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.<sup>7</sup>

The policy challenge described in this statement becomes more apparent when considered against the backdrop of the established justifications for subordinating shareholder claims in insolvency.

---

4 *Soden v British & Commonwealth Holdings plc* [1998] AC 298, per Lord Browne-Wilkinson, para. 324 (original emphasis). The statutory contract referred to is now set out in s. 33(1) of the UK Companies Act 2006 (formerly s. 14(1) of the Companies Act 1985): “The provisions of a company’s constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions.”

5 See *Soden v British & Commonwealth Holdings plc* [1998] AC 298, based on a construction of s. 74(2)(f) Insolvency Act 1986.

6 See, for instance, M Herman, “Pensioners hire Cherie Blair to sue Sir Fred Goodwin and RBS”, *The Times*, 16 March 2009; C Seib and M Waller, “Goldman Sachs case opens lawsuit floodgates on Wall Street”, *The Times*, 18 April 2010. However, the US Supreme Court’s recent decision in *Morrison v National Australia Bank Ltd* 2010 US LEXIS 5257 denying jurisdiction on the part of US courts to determine “f-cubed” cases (involving claims brought by foreign investors against foreign defendants in connection with transactions on a foreign exchange) may strongly limit the number of claims with a foreign element in future.

7 [2007] HCA 1, para. 18, per Gleeson CJ.

### The basis for subordinating shareholder claims in insolvency

Historically, the subordination of shareholder claims in insolvency arose from the necessity to adapt laws to the creditors of corporations as distinct from the creditors of individual bankrupts.<sup>8</sup> This concern was reflected in two principles: firstly, that corporate debts should be paid before distributions are made amongst shareholders – a rule which has its origins in the conception of corporate assets as a trust fund for creditors.<sup>9</sup> The second was the notion that a shareholder is precluded from denying his or her liability to contribute to the assets of an insolvent company on the ground that the shareholder was induced to buy the shares by fraud.<sup>10</sup> In modern insolvency law shareholders are referred to as the “cushion on which all other creditors rest”,<sup>11</sup> and, accordingly, equity claims in general are subordinated to the payment of other creditors. The justifications for subordination may be seen to be founded on the perception of this cushion, and can broadly be categorised as being based on contract, creditor reliance and equity. Contractually, the relationship between the shareholder and the company entails that the shareholder as a member undertakes to contribute a certain amount in satisfaction of its debts and liabilities, and it is arguably inconsistent with this position to permit the shareholder to lay claim to any part of those assets while external creditors remain unpaid.<sup>12</sup> However, where a contract to purchase shares is induced by fraud, it is voidable<sup>13</sup> and shareholders are not barred from pursuing their remedies against the company by reason of their membership.<sup>14</sup> The reliance aspect expresses the need, in ascribing a lower priority to the shareholder’s contractual claims or damages award, to take account of the relative positions of shareholders and creditors. In particular, whereas shareholders enjoy the benefits of participation in the success or prosperity of an enterprise, creditors extend credit to an entity in (at least partial) reliance upon their perception of the equity “cushion” provided by the shareholders’ investments, and would be prejudiced by a dilution of the capital reserves available to repay them if these were to be applied equally to the payment of shareholders.<sup>15</sup> In an insolvency situation, where there clearly remains no prospect of recovery from the equity cushion, the creditors shift the focus of their reliance to the expectation of priority over equity claims when the debtor’s estate is divided up.<sup>16</sup> From the perspective of achieving equity, subordination furthermore ensures that innocent creditors do not bear the economic burden of shareholder fraud remedies against the debtor company, which was involved in the

8 E S Hunt, “The trust fund theory and some substitutes for it” (1902) 12 *Yale LJ* 63.

9 *Wood v Dummer* 3 Mason 309. Hunt, “The trust fund”, n. 8 above, discusses whether the trust applies to a solvent company, or if it is limited to insolvent bodies (pp. 73–4).

10 *Oakes v Turquand* [1861–73] All ER Rep 738.

11 P Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell 2008), pp. 5–19.

12 *Houldsworth v City of Glasgow Bank* [1874–80] All ER 333, at 335; *In re Adlestone Linoleum Co* (1887) 37 Ch D 191 at 206; R Goode, *Principles of Corporate Insolvency* 3rd edn (London: Sweet & Maxwell, 2005), p. 199.

13 *Oakes v Turquand* [1861–73] All ER Rep 738.

14 See, for instance, UK Companies Act 2006, s. 655: “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 of members in respect of shares.”

15 Observed by Ebel J in *Re Genera Steel Co* (2002) 281 F3d 1173 at 1176 and 1179, a judgment in which the history of §510(b) of the US Bankruptcy Code is comprehensively discussed (Title 11, Chapter 11, USC). As will be seen below, this provision expressly subordinates claims for rescission or damages arising from the purchase or sale of shares, to payment of secured and unsecured creditors. See also M E Sproule, “A collision of fairness: Sarbanes–Oxley and s. 510(b) of the Bankruptcy Code” (2005) 24–8 *American Bankruptcy Institute Journal* 8. See also K B Davis, “The status of defrauded securityholders in corporate bankruptcy” (1983) 1 *Duke Law Journal* 1, pp. 11–12.

16 Davis, “The status”, n. 15 above, pp. 19–22.

wrongdoing and may have benefited from it.<sup>17</sup> A party who has irrevocably adopted the liabilities of a shareholder cannot appear to claim out of the debtor company's assets a sum not included in the debts and liabilities, to the payment of which he or she as a shareholder, had agreed that those assets should be devoted.<sup>18</sup> "Equity" may also be said to operate in the sense of recognising the extinction of shareholders' privileged status on the insolvency of a company:

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.<sup>19</sup>

Thus, an analysis of the relationship between shareholders and the company, between the creditors and the company, and between creditors and shareholders leads to the conclusion that subordination of shareholder claims is justified on contractual and equitable grounds. This is so although insolvency law in general<sup>20</sup> and particularly the principle of pro rata distribution<sup>21</sup> do not – as a broad rule – allow claims to be favoured on the basis of factors such as their origin or relative merits, the nature of the claimant or its relationship with the debtor. With respect to claims for loss resulting from the sale or purchase of the debtor company's shares, the question arises whether a merger should be allowed between the interests of unsecured creditors as debt-holders and the interests of shareholders as contractual or tort claimants. Or, on the other hand, if a separation should be maintained on the basis of their respective identities and the terms on which they are deemed to have contracted with the corporate debtor. The latter approach allows some consistency to be achieved in treating shareholders as shareholders regardless of whether their entitlement in a particular case is analogous to that of creditors, and continuing to accord priority to the creditors. The experience of the US and Australia, outlined below, shows how investor interests may encroach on the distribution rights of creditors, either as a result of legislative developments or by means of judicial construction.

### **Mandatory subordination in the United States and the impact of the Sarbanes–Oxley Fair Funds requirement**

In the United States Bankruptcy Code, the main principle governing distribution in Chapter 7 liquidations as well as Chapter 11 reorganisations is that of "absolute priority", whereby claims that are classed as being of a higher priority are entitled to payment in full before the lower priority claims are met.<sup>22</sup> The Chapter 7 and Chapter 11 procedures are

<sup>17</sup> Davis, "The status", n. 15 above, at p. 16.

<sup>18</sup> *In re Adlestone Linoleum Co* (1887) 37 Ch D 191, at 205.

<sup>19</sup> Callinan J's dissenting judgment in *Sons of Gvalia Ltd v Margaretic*, n. 1 above, para. 242, referring to s. 563A of the Australian Corporations Act 2001: "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."

<sup>20</sup> Davis, "The status", n. 15 above, pp. 16–18.

<sup>21</sup> Also known as the *pari passu* principle – see M Bridge, "Collectivity, management of estates and the *pari passu* principle in winding-up" in J Armour and H Bennett (eds), *Vulnerable Transactions in Corporate Insolvency* (Oxford: Hart 2003), ch. 1, para. 1.2.

<sup>22</sup> Title 11, Chapter 7, USC §726; and Title 11, Chapter 11, USC §1129(b)(2)(B)(ii).

furthermore connected by the inclusion, among the requirements for a court to confirm a Chapter 11 plan, of a stipulation that claimants shall receive under the plan an amount no less than they would receive in a Chapter 7 liquidation.<sup>23</sup> Consequently, the enforcement of the priority structure set out in Chapter 7 is essential for the proper confirmation of a Chapter 11 reorganisation plan.<sup>24</sup>

In terms of this priority structure, the claims of unsecured creditors are to be satisfied before those of shareholders. Among the ordinary (non-preferential) unsecured creditors, payment of their claims is to be made on a pro rata basis.<sup>25</sup> Thus, *pari passu* treatment operates within the framework of absolute priority, and is acknowledged as the “equality of distribution principle”.<sup>26</sup> Of particular interest is §510(b) of the Code which provides that claims for the rescission of a purchase or sale of a security of the debtor company, or damages arising from the purchase or sale thereof, or claims for reimbursement or contribution for a sale or purchase, are subordinated to the payment of secured and unsecured claims. By this rule of mandatory subordination, shareholders are precluded from recovering from the company in respect of claims arising in contract or tort on parity with unsecured creditors.<sup>27</sup> The possibility of this form of shareholder elevation is clearly excluded, and the equality of distribution principle continues to apply as between the general creditors.

With the introduction of the American Competitiveness and Corporate Accountability Act (referred to herein as the Sarbanes–Oxley Act),<sup>28</sup> in particular its Fair Funds provision §308(a), this distribution regime has undergone a modification, as the Securities and Exchange Commission (SEC) is entitled to direct that civil penalties recovered in respect of securities violations be added to a disgorgement fund for the benefit of victims of such violations. The primary purpose of disgorgement is to deter violations of the securities laws by depriving violators of their illegal profits.<sup>29</sup> Thus, although disgorged funds may often go to compensate securities fraud victims for their losses, such compensation is a distinctly secondary goal, and the measure of disgorgement need not be tied to the losses suffered by defrauded investors.<sup>30</sup> Civil penalties further the deterrent role of disgorgement by allowing the SEC to impose a financial penalty which may amount to the gross monetary gain from the securities fraud.<sup>31</sup> Consequently, neither mechanism entails the enforcement or collection of a debt as such.

A change has come about in that, while the SEC formerly had only discretion to distribute recoveries from disgorgement to injured investors and was obliged to transmit civil penalties to the US Treasury,<sup>32</sup> the Fair Funds provision now permits it to add the civil

---

23 Title 11, Chapter 11, USC §1129(A)(7)(ii).

24 D A Henry, “Subordinating subordination: WorldCom and the effect of Sarbanes–Oxley’s Fair Funds provision on distributions in bankruptcy” (2004) 21 *Bankruptcy Developments Journal* 259, p. 270.

25 Title 11, Chapter 7, USC §726(b).

26 Z Christensen, “The Fair Funds for Investors provision of Sarbanes–Oxley: is it unfair to the creditors of a bankrupt debtor?” (2005) *University of Illinois Law Review* 339, p. 347.

27 Henry, “Subordinating subordination”, n. 24 above, p. 272.

28 2002 Pub L No 107–204, 116 Stat. 745.

29 *SEC v Fischbach Corporation*, 1333 F3d 170, at 175. See also *The Investor’s Advocate: How the SEC protects investors, maintains market integrity, and facilitates capital formation*, United States SEC, available at [www.sec.gov/about/whatwedo.shtml](http://www.sec.gov/about/whatwedo.shtml).

30 *SEC v Fischbach Corporation*, 1333 F3d 170, at 175–6.

31 Securities Enforcement Remedies Act and Penny Stock Reform Act of 1990, 15 USC §78u(d)(3).

32 See *Official Committee of Unsecured Creditors of WorldCom Inc. v SEC* (2006) 467 F3d 73, at 81–2, and 15 USC §77t(d)(3)(A).

penalties proceeds to the disgorged funds and distribute these monies to the victims of the fraud. It is recognised that this has made “another potentially large category of funds available for compensation”.<sup>33</sup> This enhanced power of the SEC supports the intention underlying the Act, to “protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws”<sup>34</sup> and “crack down on fraud and wrongdoing”.<sup>35</sup> Although the operation of the provision is not limited to companies that are insolvent, the application of the Fair Funds term in a bankruptcy has meant that a shareholder whose claim against the debtor company falls for mandatory subordination in terms of §510(b) may be eligible to receive compensation as a victim of fraud *pari passu* with unsecured creditors.<sup>36</sup> In other words, the SEC’s share in the bankruptcy estate as a general unsecured creditor may be distributed to the defrauded shareholders rather than being paid over to the US Treasury.<sup>37</sup> In this way, the absolute priority rule is bypassed and, to the extent that the distinguishable (and in some respects opposing) interests of shareholders and unsecured creditors are unusually aligned,<sup>38</sup> its implications for *pari passu* treatment merit consideration.

In terms of general insolvency principles, this is clearly a departure from the established framework<sup>39</sup> whereby the payment of equity debts is made after distribution to unsecured creditors. In light of the specific requirement of mandatory subordination of shareholder claims under the US Bankruptcy Code, whereby even claims going to the root of the shareholders’ relationship with the debtor company<sup>40</sup> and of a potentially tortious nature are categorised as equity claims, this development is even more striking. Furthermore, in the field of corporate rescue law, as compared with the traditional focus of a reorganisation process, such as Chapter 11, on the debtor’s financial circumstances and recovery prospects,<sup>41</sup> Fair Funds uniquely diverts attention towards the obligation to take account of the needs of a particular group of creditors.

The consequences of implementing the Fair Funds provision §308(a) in bankruptcy were recognised by Rakoff J in assessing the penalty of the SEC in its case against WorldCom Inc.<sup>42</sup> He affirmed that, under the bankruptcy laws, the SEC’s penalty claim was

33 V Winship, “Fair Funds and the SEC’s compensation of injured investors” (2008) 60 *Florida Law Review* 1103, p. 1110. She argues, moreover, that since the passage of the Sarbanes–Oxley Act, penalties serve the dual purpose of deterring securities law violations and compensating harmed investors (p. 1118).

34 Preamble to the Sarbanes–Oxley Act.

35 Statement of President George W Bush on House of Representatives Action on the proposed “Sarbanes–Oxley Act of 2002”, 25 July 2002.

36 Christensen, “Fair Funds”, n. 26 above, illustrates this by example of a tort claim by the purchaser of an equity security that arises from the debtor’s fraudulent activity. In the absence of a Fair Funds requirement and by virtue of mandatory subordination, this claim would not achieve the same status as a general unsecured claim even though in principle a holder of a tort claim would obtain the status of a general unsecured creditor: p. 348.

37 *Ibid.* pp. 353–4.

38 Sprouse, “A collision”, n. 15 above, notes that this distribution may be received by the stockholder claimant “to the direct detriment of unsecured creditors and in potential contravention of provisions of the Code, including §510(b) and the ‘absolute priority rule’”: p. 8.

39 See, generally, Wood, *Law and Practice*, n. 11 above, at 5-02, and in particular Title 11, Chapter 7, USC §726(a), which sets out the order of priority for claims, subject to the requirement of mandatory subordination according to §510.

40 For instance, whether the purchase of shares is tainted by misrepresentation.

41 A Keay and P Walton, *Insolvency Law: Corporate and personal* 2nd edn (Bristol: Jordans 2008), para. 1.3.

42 *SEC v WorldCom Inc.*, 273 F Supp 2d 431, United States District Court for the Southern District of New York, affirmed on appeal: *Official Committee of Unsecured Creditors of WorldCom Inc. v SEC* 467 F3d 73 (2006) (US Court of Appeals for 2nd Circuit).

treated simply as another claim by one of many unsecured creditors.<sup>43</sup> However, he acknowledged that while §308(a) gave the SEC an opportunity to pay any penalty it recovered to shareholder victims rather than to the US Treasury, it could not properly premise the size of its penalty on the basis of such disbursement. This move would arguably run afoul of the mandatory subordination provisions of the Code, given that there was no suggestion in §308(a) that Congress intended to accord a greater priority to shareholders in bankruptcy than they had previously enjoyed. Rakoff J, however, considered it to be acceptable for the SEC to give its penalty recovery to shareholder victims or take *some* account of shareholder loss in formulating the size and nature of its penalty.<sup>44</sup> The approved settlement provided that the penalty recoveries would be directed to defrauded shareholders in accordance with the Fair Funds provision.

Rakoff J's decision was upheld on appeal following objections by an official committee of WorldCom's unsecured creditors (the Committee) to the exercise of the district court's discretion in approving the plan.<sup>45</sup> The Committee took issue with the SEC's distribution plan on the ground that, in the absence of sufficient funds to compensate all the victims of WorldCom's fraud, several groups of investors were excluded from sharing in the amount collected from WorldCom. Among the investors excluded were those who had recovered 36 per cent or more on their claims under the Chapter 11 reorganisation plan or through the sale of their securities, and investors who made a net profit on their combined purchase and sales of WorldCom securities during the period in which the fraud occurred. The Committee further contended that the ordinary judicial test for reviewing the distribution of disgorged profits – that is whether the distribution was conducted in a “fair and reasonable” manner<sup>46</sup> – should not apply to the review of Fair Funds plans. The Committee especially objected to the exclusion of creditors who had received more than 36 per cent in the bankruptcy proceedings or through the sale of their WorldCom securities as flying “in the face of the strong public policy that puts the rights of bondholders ahead of those of shareholders”.<sup>47</sup> With regard to the implications for the relationship between creditors, the appeal Court recognised, in the same manner as the district court, the tension between the priority assigned to claims under the Bankruptcy Code and the Fair Funds provision, which empowered the SEC to distribute funds among injured investors outside the bankruptcy proceeding.<sup>48</sup> The court saw no indication in the Fair Funds provision, however, that the SEC must follow the Bankruptcy Code's claim priorities when developing a distribution plan, and it considered that in the absence of such an indication it was not its role to mitigate this tension.<sup>49</sup> It found that the district court was required only to determine that the SEC's distribution plan fairly and reasonably distributed limited Fair Fund proceeds among potential claimants, and it had properly exercised its discretion in approving the plan.<sup>50</sup> In this way, a distribution outcome in the context of bankruptcy which did not accord with the equality of distribution principle (or *pari passu* treatment) was rendered

---

43 *Official Committee of Unsecured Creditors of WorldCom Inc. v SEC* 467 F3d 73 (2006) (US Court of Appeals for 2nd Circuit), p. 434.

44 *Ibid.* emphasis added. In the result, the penalty proposed and approved by the court was \$750 million, 75 times greater than any prior such penalty.

45 *Ibid.* The question whether the committee had exceeded its statutory authority as a creditors' committee in bringing the proceedings was argued before the court, pp. 77–81. Provision governing powers of creditors' committees: Title 11, Chapter 11, USC §1103.

46 The test applied in the court *a quo*: *SEC v WorldCom Inc.*, n. 42 above.

47 *Official Committee*, n. 42 above, p. 85.

48 *Ibid.*

49 *Ibid.* p. 85.

50 *Ibid.*

acceptable by framing the issue for resolution not as whether the SEC was constrained to observe the Bankruptcy Code's priorities in making distributions; but rather by inquiring whether it fell outside the scope of the SEC's authority to make distributions that were inconsistent with such priorities.

The actual compromise and settlement between WorldCom and the SEC was approved by the Bankruptcy Court for the Southern District of New York.<sup>51</sup> Gonzalez J refrained from deciding whether the ultimate distribution to securities holders contemplated by the settlement violated the absolute priority rule and mandatory subordination under the Code. In his opinion, even if this were found to be the correct legal interpretation from a bankruptcy standpoint, there remained a number of legal issues to be addressed. The nature of these issues, as well as any other issues that may be raised in litigation to subordinate the claim, was such as to furnish sufficient doubt as to the outcome of any litigation to subordinate the claim of the securities holders. He took this uncertainty among other factors as providing support for the settlement, and went further to state that in considering the approval of a settlement the court was not required to resolve the "underlying legal issues" related to the settlement.<sup>52</sup> In the court's determination, the settlement fell within the range of reasonableness and was fair and equitable and in the best interests of the debtors' estates.<sup>53</sup> As noted above, the mere fact of inconsistency with the absolute priority rule did not influence the court against approving the settlement, and this incompatibility did not have a bearing on the "fairness and reasonableness" of the settlement that had been reached – it was acknowledged as constituting no more than a legal issue and was thus separable from the matters to be taken account of in sanctioning the settlement.

This reluctance to resolve the contradiction between approving a settlement with the SEC, whereby a victims' restitution fund would be established from the settlement proceeds, and the likelihood that the distribution of the same monies would potentially allow a division contrary to §510(b) and *pari passu* distribution among ordinary unsecured creditors was echoed in *Re Adelpbia Communications*.<sup>54</sup> Gerber J acknowledged that the victims' restitution fund would be distributed largely to victims who were equity security holders or investors of debt securities who would find themselves subordinated under §510(b) if they asserted claims in Chapter 11 cases. But he did not consider this to be a satisfactory basis for disapproving the settlement, as, firstly, these parties would not be sharing in the assets of the estate but under a plan created and owned by the government; and, secondly, the uncertainty surrounding the disbursement of Fair Funds vis-à-vis the absolute priority rule could be taken as supporting the view that settlement would be appropriate in the circumstances.<sup>55</sup> It is strongly indicative of the very real difficulty that the courts have faced in these matters that as with Gonzalez J's judgment in the *WorldCom* matter, Gerber J took a negative element – namely the uncertainty arising from implementing a Fair Funds distribution in the light of the absolute priority structure – as evidence of the desirability of a settlement.

It may be seen that the legislature's omission to reconcile the effect of the Fair Funds requirement with the current bankruptcy structure has been matched by the judicial demurral highlighted above. The imperative of facilitating a settlement in the cases outlined above has enabled the courts to manoeuvre around the difficulty of making a choice between the competing objectives of eliminating fraud and preserving the established

51 *In re WorldCom Inc.*, Case No 02 B 13533 (AJG): August 6, 2003.

52 *Ibid.* p. 4 of judgment.

53 *Ibid.*

54 *In re Adelpbia Communications Corporation* (2005) 327 BR 143.

55 *Ibid.* pp. 168–71.

bankruptcy distribution scheme. Consequently, no views have emerged as to which is to be upheld or promoted over the other, and this underscores the uncertainty attendant on the conception of *pari passu* treatment as a matter of public policy:<sup>56</sup> it does not anticipate situations where having regard to the public interest might lead to the conclusion that the enforcement of equal treatment should be extended to non-creditor parties. The apparent inconsistency between §510(b) of the Code and the Fair Funds provision has been widely noted,<sup>57</sup> and in the absence of any statutory indication as to whether the application of the Fair Funds provision should alter the established distributional priority scheme in the Bankruptcy Code,<sup>58</sup> commentators have advanced some persuasive arguments regarding whether these dissonances should be viewed in a positive or negative light. Before these arguments may be considered in greater detail, it is necessary to introduce the developments in Australian law which temporarily produced a similar outcome.

### ***Sons of Gwalia Ltd v Margaretic* in Australia: the High Court's decision and its consequences**

*Sons of Gwalia Ltd v Margaretic* is a recent decision of Australia's highest court,<sup>59</sup> the salient facts of which are as follows. In August 2004, Mr Margaretic (M) bought 20,000 fully paid ordinary shares in the capital of Sons of Gwalia Ltd (Gwalia). The company was listed on the Australia Stock Exchange and it was from this market that M made his purchase. A few days after M was entered on the register of the company's members, administrators were appointed to distribute the assets of the company as in a winding-up.<sup>60</sup> Upon the appointment of the administrators, the Gwalia shares bought by M became completely worthless. M claimed compensation from Gwalia, alleging a breach of the securities laws. The administrators of Gwalia sought to prevent him from proving his claim in the deed of company arrangement as a creditor, rather than a member. Under s. 563A of the Australia Corporations Act 2001:

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.<sup>61</sup>

56 A connection made in the House of Lords' judgment in *British Eagle International Airlines v Compagnie Nationale Air France* [1975] 1 WLR 758 (HL) in refusing to uphold an airline netting arrangement on British Eagle's insolvency. See, however, more recent authorities declining to give effect to an independent (i.e. non-statutory) notion of public policy in relation to the rule: *Perpetual Trustee Co. Ltd v BNY Corporate Trustee Services Ltd* [2009] EWCA Civ 1160 (England and Wales Court of Appeal); *International Air Transport Association v Ansett Australia Holdings Ltd* [2008] HCA 3 (High Court of Australia).

57 Christensen, "Fair Funds", n. 26 above; Sprouse, "A collision", n. 15 above; and Henry, "Subordinating subordination", n. 24 above. For a discussion from an international perspective, see J Sarra, "From subordination to parity: an international comparison of equity securities law claims in insolvency proceedings" (2007) 16 *International Insolvency Review* 181.

58 Christensen, "Fair Funds", n. 26 above, pp. 369–75.

59 *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1. Due to the constraints of space, the procedural history of the litigation is not set out in this paper. For a helpful summary, combined with a detailed analysis of the High Court judgment, see A Hargovan and J Harris, "The shifting balance of shareholders' interests in insolvency: evolution or revolution?" (2007) 31 *Melbourne University Law Review* 591.

60 Under s. 463A(1) of the Corporations Act 2001.

61 Although the matter was argued on the basis that the issue for decision turned on the proper construction of s. 563A, this was reinforced by cl. 4(2)(d) of the deed of company arrangement entered into by Gwalia: "For the avoidance of doubt, payment of any debts or liabilities owed by the Company to Members in the Members' capacity as a member of the Company, whether by way of dividends, profits or otherwise are, to the extent contemplated by Section 563A of the [Corporations Act 2001] and the general law, to be postponed until all debts owed to, or claims made by, Creditors have been satisfied."

The questions for determination were therefore whether M's claim was a provable debt, and if so whether it ranked for payment with non-shareholder creditors, or was postponed to the satisfaction of their claims. Its ranking with non-shareholder creditors would depend on whether M's claim fell within the s. 563A subordination of debts owed to a member as a member. Thus, although there is no statutory provision equivalent to §510(b) of the US Bankruptcy Code prescribing mandatory subordination of the sort of claim brought by M, attention focused on the nature of the debts which could be considered as owing to a person *qua* member under s. 563A.

Two important factors were noted that had a bearing on this case. The first was the historical significance of s. 563A, which could be traced back to a time when the separate legal personality of a company had not been fully recognised, and the distinction between corporations and partnerships was less marked. It was an established rule of partnership law that a partner in a bankrupt firm could not prove in competition with debts of outside creditors upon a dissolution, as this would permit him or her to diminish partnership assets to the prejudice of the firm's creditors, who were also his or her own creditors. This rule now formed part of the conception of a company's existence as an entity separate from its members.<sup>62</sup> Another influential consideration, relevant to the raising and maintenance of capital, was the established principle that the creditors of a company which is being wound up have a right to look to the paid-up capital as the fund out of which their debts are to be discharged.<sup>63</sup> This common law principle had its origins in the nineteenth century,<sup>64</sup> and had been given statutory effect in successive Companies Acts. These factors provided the background to the operation of s. 563A and demonstrated the wider implications of the decision, beyond the resolution of this matter.

The majority of the High Court concluded that M's claim was not a debt owed to him in his "capacity as a member" of Gwalia, whether by way of dividends, profits or otherwise. Accordingly, the claim was not to be postponed by s. 563A of the Corporations Act 2001 to claims made by "persons otherwise than as members of the company". In determining whether the type of claim brought by M fell to be subordinated under s. 563A, analysis centred on the interpretation of the phrase "in the person's capacity as a member of the company". The provision itself did not manifest any clear legislative policy, as compared with the mandatory subordination provision §510(b) of the US Bankruptcy Code. However, it was clear to the court that it did not embody a general policy that "members come last" in an insolvency:

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 [s. 563A] rejects such a general policy.<sup>65</sup>

The criteria for subordination were thus based on the character of the debt rather than the identity of the claimant. In this case, the claim made by M was not founded on any rights he obtained or obligations incurred by virtue of his membership of Gwalia. M did not seek to recover any paid-up capital or to avoid any liability to contribute to the company's capital. His membership of the company was not definitive of the capacity in which he made his

62 *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1, paras 3–4.

63 Gleeson CJ expressed doubts regarding the modern significance of this notion: "Statutory manifestations of that principle have been modified over the years, and it may be doubted that it reflects the reality of modern commercial conditions, where assets and liabilities usually are more significant for creditors than paid-up capital. As Lord Browne-Wilkinson said in *Soden v British & Commonwealth Holdings plc* [1998] 2 LRC 225, at 232, it is "wholly irrelevant to the position of a member who has acquired fully paid shares on the market": para. 5.

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

65 *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1, para. 19. See also para. 119.

claim, and the obligation which he sought to enforce was not an obligation which the Corporations Act created in favour of a company's members. The obligations arose by virtue of Gwalia's conduct in relation to the statutory duties alleged to have been breached – in particular the prohibition against engaging in misleading or deceptive conduct – rather than from a legislative prescription of the rights and duties of company members. Gwalia's contravention of "statutory norms of behaviour"<sup>66</sup> rendered it liable to provide damages or other relief at the suit of any person who had suffered, or was likely to suffer, loss and damage as a result of the contravention. Accordingly, s. 563A did not apply to M's claim, as it was not a debt owed to him in his capacity as a member of Gwalia.

Callinan J dissented from this construction of s. 563A. He considered that the scope, objects and history of the Corporations Act 2001, the language of s. 563A and the context in which the provision appeared, the relevant case law and the desirability of maintaining coherence and fairness within the law, all pointed towards the construction that s. 563A precluded the treatment of M as a creditor on parity with other unsecured creditors. He drew attention to the conformity of this result with the typical shareholder/creditor relationship:

... up to the point of insolvency, liquidation or administration of a company, its members enjoy superior opportunities, rights and advantages to creditors, yet the latter are no less likely to be disadvantaged by deceptive conduct of a company lying in a failure to comply with the continuous disclosure rules. There can be no doubt that the financial capacity of a company to satisfy its obligations to all of those who deal with or rely on it, is a matter of continuing interest and concern to them.<sup>67</sup>

He noted that parity would also distort inter-shareholder relationships, given that all shareholders of Gwalia had been equally wronged and induced by the company to hold on to their shares. Recent purchasers such as M would gain a large advantage over other, equally wronged, longer-term members if their claims were accorded the status of non-membership debts. He thus concluded that M's claim should be postponed to the satisfaction of all non-member creditor debts.

It may be seen how defrauded shareholders in the US and Australia respectively found themselves in similar positions; as a result of the Fair Funds legislation in one jurisdiction and of judicial construction in the other. Concern arose in Australia over the implications of the *Sons of Gwalia* decision, which included its potential to facilitate the participation of equity holders in insolvencies and workouts; encourage litigation by shareholders or the likely use of compensation claims as leverage in insolvencies; and an increase in the tendency of banks to request security when lending to a listed company.<sup>68</sup> Notwithstanding the recommendation by the national Corporations and Markets Advisory Committee not to reverse the effects of the *Sons of Gwalia* judgment,<sup>69</sup> the Australian government has released draft legislation overturning the decision. The Corporations Amendment (No 2) Bill 2010 explicitly provides that claims in relation to the buying, selling, holding or otherwise dealing in shares are to be ranked equally and paid after satisfaction of all creditors' claims. The consequences of the *Sons of Gwalia* decision with respect to reduced access to debt finance and the increased cost

---

66 *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1, para. 10.

67 *Ibid.* para. 241. See also text accompanying n. 19 above.

68 See D Loxton, "Shareholder claims in corporate failure: why is Australia ditching *Gwalia*?" (2010) *Journal of International Banking and Financial Law* 244.

69 Corporations and Markets Advisory Committee, *Shareholder Claims against Insolvent Companies: Implications of the Sons of Gwalia decision* (Government of Australia, 2008). Hereafter referred to as the CAMAC Report.

and complexity of insolvent administrations, have thus been addressed.<sup>70</sup> To this extent, the debate in Australia regarding the use of the *qua*-member construction approach to confer parity on investors appears to be closed. As other jurisdictions take this direct, legislative approach to clarifying the position, certainty may be expected to dominate this area of law. However, this does not exclude the potential for mandatory subordination to be apparently undermined by another legislative instrument which is underpinned by similarly compelling policy reasons, as borne out by the Sarbanes–Oxley Fair Funds experience. For this reason, the consideration which follows of the arguments supporting parity focuses principally on the US position, although it incorporates more general observations which may be relevant to the legal position in other countries.

### Can parity be justified as a progressive move in insolvency distribution?

The Fair Funds provision has been recognised as a positive development on the ground that distributing the funds of a bankrupt estate to shareholders as tort claimants is essential to a modern system of corporate governance.<sup>71</sup> It reflects an appropriate response to evolving financial markets,<sup>72</sup> in particular, the fact that the interests of creditors and shareholders have changed since the era during which the theories supporting the mandatory subordination of shareholder claims were developed.<sup>73</sup> It is worth noting that more than a quarter of a century ago, the argument was already being advanced that the sophistication in financial law and practice that had evolved since the inception of the subordination doctrine severely undermined the policy basis for protecting the creditors.<sup>74</sup> Shareholders were seen as constituting a more broadly dispersed group and no longer just a minor assembly of entrepreneurs and local investors, while creditor groupings had yielded to the dominance of financial institutions in place of comparatively small trade creditors and individual debt holders.<sup>75</sup> Both modern business creditors and modern shareholders are seen to have greater resources at their disposal to evaluate a corporation's financial position, and a stronger understanding of the factors that affect solvency than they had when mandatory subordination was first introduced.<sup>76</sup> Thus, the comparative abilities of the debt and equity classes to protect themselves from fraud and to represent their interests vigorously in a bankruptcy proceeding may be taken to have changed.<sup>77</sup> On this view, there is no conflict between the absolute priority rule and the operation of the Fair Funds provision in a bankruptcy. Not only is the result entirely in accord with the reality of the circumstances of creditors and shareholders in current times, it is argued that it also

---

70 See Explanatory Note to the Corporations Amendment (No 2) Bill 2010, paras 2.6–12.

71 Henry, "Subordinating subordination", n. 24 above, at p. 262.

72 Ibid.

73 Ibid. p. 284. See Duffy's discussion of the core issues in *Sons of Gwalia* from the perspective of the "stakeholder" and "nexus of contracts" theories of the corporation: M Duffy, "After *Sons of Gwalia* – some perspectives on the position of shareholders and creditors and the question of law reform", (2008) 22 *Australian Journal of Corporate Law* 161.

74 Davis, "The status", n. 15 above, pp. 28–9.

75 Ibid; Henry, "Subordinating subordination", n. 24 above, at p. 284.

76 Henry, "Subordinating subordination", n. 24 above, at p. 284.

77 Ibid; Davis, "The status", n. 15 above, p. 29, in fact argued that the *shareholders* had limited means to acquaint themselves with the debtor's financial situation. Likewise, the CAMAC Report, n. 69 above, notes that in practice, existing shareholders may have little or no real day-to-day capacity to monitor or control corporate disclosures or other corporate conduct and may be as misled as new investors by corporate misconduct (para. 3.4).

represents an acceptance that blanket shareholder subordination is a rigid approach which can yield unfair outcomes.<sup>78</sup>

Moving beyond the legal position in the US, there are further broad justifications which may be identified in favour of elevating shareholder claims. The first of these is that the inherent dynamism of public policy must extend to a rule such as *pari passu*. That is to say, since *pari passu* has been upheld and applied as being based on public policy,<sup>79</sup> and public policy is based on the current needs of the community,<sup>80</sup> in principle the concept of rateable treatment should be equally malleable to accommodate the effect of the changes in the relationship between shareholders and creditors in modern times. Indeed, it was acknowledged, among the arguments for non-subordination preceding the recent Australian Corporations Amendment Bill, that the positions of shareholders and creditors in an insolvency are not wholly dissimilar:

[I]n some companies, such as large listed companies, ordinary shareholders, even institutional shareholders, have limited practical ability to direct the company and in reality may have no greater power than creditors. They therefore need a comparable level of protection in an insolvency.<sup>81</sup>

Since the law develops by perpetually drawing new values and solutions from the life of the community<sup>82</sup> – a feat attained partly through the development of new law, and partly through standards and principles which are implicit in particular branches of the law such as “reasonableness” and “public policy”<sup>83</sup> – a change of this type is not beyond the realm of possibility. Moreover, it has been argued that some of a company’s securities violations may have occurred with the collusion of some of its creditors (albeit that their actions may not attract specific civil or criminal liability);<sup>84</sup> and since trade creditors dealing with such a company will typically have their invoices paid until the company is on the verge of insolvency, they are not invariably in the position of parties who have lost everything to a debtor.<sup>85</sup> In the light of all these factors, it would seem inconsistent with the development of public policy that mandatory subordination should override the possibility of any payment to defrauded shareholders on the same priority with the unsecured creditors of a company. It is arguably desirable that the understanding of “equality of distribution” should evolve in tandem with this re-balancing of the relative positions of creditors and shareholders. Indeed, remaining faithful to the theoretical conception of the risks assumed by either grouping would achieve the result that the law pulls in a different direction from the realities of commerce and, thus, fails to meet the broad goal of public policy to serve the current needs of the community.

Another factor which should enable the acceptance of *pari passu* treatment for defrauded shareholders vis-à-vis unsecured creditors is the notion that companies are social

---

78 A Hargovan and J Harris, “*Sons of Gwalia* and statutory debt subordination: an appraisal of the North American experience” (2007) 20 *Australian Journal of Corporate Law* 265.

79 See *British Eagle* case, n. 56 above; and *Attorney General v McMillan & Lockwood* [1991] 1 NZLR 53. See, however, more recent comments narrowing the scope of this public policy aspect of the rule in *Perpetual Trustee* and *LATA v Ansett*, both cited in full at n. 56 above.

80 P H Winfield, “Public policy in the English common law” (1928) 42 *Harvard Law Review* 76–102, p. 92.

81 CAMAC Report, n. 69 above, para 3.3.1. See also Explanatory Note, n. 70 above, para. 2.23.

82 G Paton, *Jurisprudence* (Oxford: Clarendon 1972), p. 199.

83 *Ibid.*

84 K Cordry, “Categorical subordination: still kicking?” (2006) 24(10) *American Bankruptcy Institute Journal* 8, p. 51.

85 *Ibid.*

enterprises<sup>86</sup> – their existence is required to produce consequences beneficial to society<sup>87</sup> and their activities should accordingly be consonant with the public interest.<sup>88</sup> This includes making profits for the shareholders, which becomes a mechanism for promoting the public interest, and not an end in itself.<sup>89</sup> The classification of companies as social enterprises entitles the state to intervene in order to safeguard the public interest and ensure compliance with publicly acceptable ethical standards while they are going concerns.<sup>90</sup> On this basis, it is submitted that this entitlement should reasonably continue into the insolvency of a company and would be even more pertinent to a reorganisation process which offers the prospect of survival of a company. The public interest receives protection through the deterrence of fraud or dishonest behaviour on the part of companies, the preservation of financial integrity and commercial morality in the market, and the encouragement of investment or enterprise within society. These concerns were prominent in the debates leading to the enactment of the Sarbanes–Oxley Act<sup>91</sup> and, from an enforcement perspective in particular, actions such as disgorgement and restitution to injured investors promote economic and social policies, including investor confidence in the fairness and transparency of securities markets and the deterrence of future violations.<sup>92</sup> It is similarly noted by the Australian legislature that “aggrieved shareholder claims” can act as a form of private enforcement and help promote the integrity of corporate conduct, to the benefit of lenders and the market generally, and not only shareholders.<sup>93</sup> This resonates with the view that from a social-enterprise perspective financial impropriety on the part of managers and inadequate methods of accountability and control are no more to be tolerated in the corporate sphere than they are within the organs of government.<sup>94</sup> Thus, to accept that insolvency law affects community interests – and is bound to recognise and safeguard such interests<sup>95</sup> – is to extend the social-enterprise/public-interest aspect of a company’s existence into its demise. A virtuous circle is identifiable between the efficiency

86 J E Parkinson, *Corporate Power and Responsibility: Issues in the theory of company law* (Oxford: Clarendon 1993), p. 23. See also Armour et al.’s submission that the goal of corporate law is to advance overall social welfare: J Armour, H Hansmann and R Kraakman, “What is corporate law?” in R Kraakman, J Armour, P Davies et al., *The Anatomy of Corporate Law: A comparative and functional approach* 2nd edn (Oxford: OUP 2009), ch. 1, p. 28.

87 Parkinson, *Corporate Power*, n. 86 above, p. 33.

88 Parkinson, *Corporate Power*, n. 86 above, pp.23–6.

89 Ibid. p. 24.

90 Ibid. In similar vein, Cheffins finds support for the proposition that lawmakers should take action when markets threaten to undermine key community ideals: B Cheffins, *Company Law: Theory, structure and operation* (Oxford: Clarendon 1997), p. 153.

91 148 Cong Rec H4478-85 (“Corporate reform needed” – House of Representatives); 148 Cong Rec H5462-80 (conference report on proposed legislation, House of Representatives); and 148 Cong Rec S7350-65 (conference report on proposed legislation, Senate).

92 SEC, *Report Pursuant to Section 308(c) of the Sarbanes–Oxley Act of 2002*, available from [www.sec.gov/news/studies/sox308creport.pdf](http://www.sec.gov/news/studies/sox308creport.pdf), pp. 19–20.

93 See Explanatory Note, n. 70 above. This echoes the CAMAC Report’s (n. 69 above) position: “Claims by aggrieved shareholders can serve as a market-based deterrence, enforcement and recovery mechanism in support of required standards of corporate conduct” (para. 3.4).

94 Parkinson, *Corporate Power*, n. 86 above, p. 202. Indeed, Attenborough notes that the very largest corporations have greater economic power than many nation states: D Attenborough, “How directors should act when owing duties to the companies’ shareholders: why we need to stop applying Greenhalgh” (2009) *International Company & Commercial Law Review* 339, p. 346.

95 *Insolvency Law and Practice: Report of the Review Committee*, Cmnd 8558 (1982), paras 198(i), 240 and 1734.

of financial markets resulting from timely and accurate disclosures,<sup>96</sup> and a reduced risk of insolvency as fewer companies fail through poor management and the delayed evidence of financial difficulty.

Insolvency law jurisprudence<sup>97</sup> and policy<sup>98</sup> do not deny the relevance of public interests, but do not answer fully the important question of the extent to which they can (or should) be accommodated in practice. This has provided fertile ground for debate, in particular as regards the ability of social interests to impinge on creditors' rights of recovery.<sup>99</sup> However, in the operation of Sarbanes–Oxley Fair Funds provisions, there is no direct encroachment on the assets available to unsecured creditors since the SEC recovers restitution by way of civil penalties and disgorgement levied on a wide body of persons and pays to the injured investors out of funds that would otherwise be paid to the Treasury.<sup>100</sup> The new position is therefore arguably defensible on the ground that it does not interfere with the equal treatment of creditors per se, as the disbursements are not being made from funds that they would otherwise be entitled to. In fact, in some cases, the SEC has made payment of disgorgement or civil penalties to investors via a bankruptcy trustee “for distribution to creditors, including investors”.<sup>101</sup> Although this particular parity may seem inconsistent with the distribution structure enshrined in the absolute priority rule, in reality the scope for interference with this structure is reduced by factors pertinent to the operation of Fair Funds. These include the difficulty faced by the SEC in satisfying strict judicial requirements for disgorgement orders;<sup>102</sup> the power of the SEC to exercise a discretion to either transmit its recoveries to the Treasury or use them to compensate the defrauded investors;<sup>103</sup> the likelihood that such distributions may be foregone in situations where it proves not to be cost-effective to make them;<sup>104</sup> and the principle that compensation is not the same as satisfaction of the shareholders' claims.<sup>105</sup> The impact of the application of Fair Funds on the maintenance of the insolvency distribution structure may thus not be as profound as it might appear at first glance. It is accordingly proposed that for insolvency law to be seen to do more than pay lip-service to notions of the community welfare, it should give perceptible effect to such market-related concerns as those targeted by the Sarbanes–Oxley Act, particularly if this offers the prospect of reducing the incidence of insolvency in those same markets. Moreover, it would show that the demands of commercial morality placed upon a company during its lifetime (as

---

96 CAMAC Report, n. 69 above, para. 2.4.3: “Financial markets are more efficient and less volatile to the extent that companies provide timely and accurate disclosures about their real financial position and prospects.”

97 See, for instance, A Keay, “Insolvency law: a matter of public interest?” (2000) 51 *NILQ* 509–34; and V Finch, *Corporate Insolvency Law: Perspectives and principles* 2nd edn (Cambridge: CUP 2009), ch. 2.

98 *Insolvency Law and Practice*, n. 95 above, paras 198(i), 240 and 1734; Law Reform Commission, *General Insolvency Inquiry*, Report No 45 (Commonwealth of Australia, 1988), para. 33.

99 The various views have been outlined in some detail by Finch, *Corporate Insolvency Law*, n. 97 above.

100 See SEC, *Report*, n. 92 above, pp. 3–5. See also Christensen, “Fair Funds”, n. 26 above, p. 371.

101 SEC, *Report*, n. 92 above, pp. 10, 12 and 16.

102 *Ibid.* pp. 18–19 and 23–4. A reading of the Fair Funds provision shows that it cannot operate in the absence of a disgorgement order, to which the SEC may add civil penalties. There is a danger of a practice developing whereby the SEC seeks token disgorgement amounts in order to facilitate the distribution of massive corporate penalties to investors: B Black, “Should the SEC be a collection agency for defrauded investors?” (2008) 63 *Business Lawyer* 317, at p. 330.

103 SEC, *Report*, n. 92 above, pp. 5 and 10–11.

104 *Ibid.* pp. 3–5.

105 *SEC v Fischbach Corporation* 1333 F3d 170; and SEC, *Report*, n. 92 above, pp. 19–20. Winship, “Fair Funds”, n. 33 above, points out that the losses sustained by investors often dwarf the profits made by the violators and thus recoveries only represent a fraction of the amounts lost (5–6% in the case of WorldCom), p. 1125.

evidenced by measures including the Sarbanes–Oxley Act)<sup>106</sup> are accorded the same significance on its insolvency.

Focusing more narrowly on debtor/creditor and inter-creditor relationships, one might also contend for an acceptance of the improved position of shareholders relative to unsecured creditors on the ground that creditors generally have a number of alternatives open to them for the purpose of protecting themselves from the consequences of a debtor's insolvency. They are often able to engage in processes to determine the probability of the debtor's default in advance; they may obtain personal guarantees or security; require information which demonstrates the debtor's continuing creditworthiness, and take insurance against the risk of default.<sup>107</sup> It is noted that apart from their ability to negotiate for contractual protections, many creditors are well-diversified, in the sense that each debt contract only has a small impact on their financial status.<sup>108</sup> A typical lender is ordinarily well-situated to absorb the loss associated with the failure of a single business enterprise, whether this lender takes the form of a trade creditor with numerous customers or a bank with a large number of corporate borrowers.<sup>109</sup> The historical necessity for granting rigid creditor protections as a quid pro quo for the limited liability enjoyed by shareholders is therefore distinguished from modern commercial practice, where major business creditors rely not on the law, but on contract, credit agencies and a host of other self-help measures to safeguard their interests.<sup>110</sup> The reach of creditor influence is evidenced by the fact that much of the concern regarding the implications of the *Sons of Gwalia* decision was directed towards the effects on debt finance for companies. It was perceived that there would be a reduced availability or increased cost of finance and lenders would be more likely to seek security or guarantees and impose restrictive conditions on loans.<sup>111</sup> Trade creditors would have increased recourse to retention of title agreements, or factor the added risk of non-recovery in insolvency into their costs of goods or services.<sup>112</sup> It followed, therefore, that explicit statutory subordination of shareholder claims would facilitate the provision of credit to companies and, from the standpoint of credit providers, reduce risk premiums and the imposition of onerous terms and conditions.<sup>113</sup>

In addition, as between creditors *inter se*, it is evident that many of the rules of insolvency distribution governing their relationship are already underpinned by notions of fairness. Drawing from the example of English insolvency law, in the validation of pre-insolvency dispositions, transactions which might result in certain creditors being paid in full at the expense of other creditors who will only receive a dividend may be upheld where special circumstances exist making such a course desirable in the interests of the unsecured creditors as a body.<sup>114</sup> Similarly, a preferential transaction brought about by proper

---

106 See further Cheffins, *Company Law*, n. 90 above, discussion on the ways in which the state will intervene to ensure fairness in the treatment of company participants, effective participation in corporate affairs, the protection of community ideals, and the preservation of morality in the market system, pp. 142–58.

107 Cheffins, *Company Law*, n. 90 above, pp. 501–2. A view also shared by Davis, “The status”, n. 15 above.

108 Cheffins, *Company Law*, n. 90 above, p. 502.

109 *Ibid.*

110 Armour et al., “What is corporate law?”, n. 86 above, make this observation in advancing the argument that corporate law is useful as a foundation and supplement to contractual protections for creditors, at p.72.

111 CAMAC Report, n. 69 above, para. 2.4. See also paras 2.6–9 of Explanatory Note, n. 70 above.

112 CAMAC Report, n. 69 above, para. 2.4.

113 Explanatory Note, n. 70 above, para. 2.12.

114 *Re Gray's Inn Construction Co. Ltd* [1980] 1 WLR 711, at 717D and 718 A–C; *Re J Leslie Engineers Co. Ltd (in liq)* [1976] 1 WLR 292, at 305; *Denney v John Hudson & Co. Ltd* [1992] BCLC 901, at 904; and *Re Tain Construction Ltd* [2003] EWHC 1737, paras 14–17.

commercial considerations<sup>115</sup> or a late floating charge granted to creditors involved in efforts to revive a struggling company<sup>116</sup> have been countenanced, notwithstanding the consequences for equal treatment. Defences based on the “ordinary course of business”, entitling creditors to retain benefits from preferential transactions, are also a feature of US and Australian insolvency law.<sup>117</sup> If these differences among creditors may be accepted on the grounds of fairness, strong support may be lent to a claim by injured shareholders to similar treatment on the grounds of procedural fairness.<sup>118</sup> Procedural fairness relates to the fairness of the contracting process,<sup>119</sup> encompasses the methods which market participants use to negotiate and formulate transactions, and is breached where the transactors do not have a chance to make agreements freely and knowingly.<sup>120</sup> Where shareholders have purchased shares on the basis of fraudulent misrepresentations, there is a clear absence of procedural fairness. Injured investors are required to prove the fact of the dishonest inducement, together with their dependence thereon and consequent loss, to the satisfaction of a court in order to be awarded damages<sup>121</sup> – a burden conceded to be a difficult one to discharge, in the analysis following *Sons of Gwalia*.<sup>122</sup> It is therefore arguable that their entitlement to fairness (connoting similar treatment to unsecured creditors) is judicially established in comparison to the notion of creditor reliance on capital reserves, which exists as a mere presumption of doubtful influence.<sup>123</sup> In addition, to the extent that the concept of fairness is taken to encompass a moral element,<sup>124</sup> it would seem even more important that it should avail relief in the case of involuntary debt (that is, the defrauded shareholders) compared with fairness based on commercial expediency (to wit, the general creditors in whose favour normally voidable transactions are adjusted). Extending this equitable treatment to accommodate the defrauded shareholders thus accords with the same principle which enables creditors to adjust their own relationships, and would not significantly distort existing insolvency processes or relative creditor positions within the unsecured rank. Furthermore, it can be reconciled with an important rule of equity, namely that, where trustees have made a fraudulent conveyance, the loss should fall on the beneficiaries rather than on a bona fide purchaser for value.<sup>125</sup>

115 *Re MC Bacon Ltd* [1990] BCLC 324, at 336; *Levis v DKG Contractors* [1990] BCLC 903, at 910; *Re Fairway Magazines Ltd* [1992] BCC 924, at 930; *Wills v Corfe Joinery Ltd* [1998] 2 BCLC 511, at 512.

116 Insolvency Act 1986, s. 245(2)(b); *Re Matthew Ellis Ltd* [1933] Ch 458.

117 US Bankruptcy Code, §547(c); Corporations Act 2001 (Australia), s. 588FG(2).

118 Described by S Smith, “In defence of substantive fairness” (1996) 112 *Law Quarterly Review* 138, p. 140; and Cheffins, *Company Law*, n. 90 above, p. 143.

119 Smith, “In defence”, n. 118 above.

120 Cheffins, *Company Law*, n. 90 above; Smith, “In defence”, n. 118 above.

121 Under contract and traditional tort law principles: Davis, “The status”, n. 15 above, p. 39. Reliance is presumed, under the “fraud on the market” theory in the US – see *Basic v Levinson* (1988) 485 US 224. See also para. 3, Sch. 10A of the UK Financial Services and Markets Act 2000.

122 CAMAC Report, n. 69 above, at para. 3.2.2: obtaining a remedy through litigation as an aggrieved shareholder can be a difficult task, as it turns on whether a shareholder can establish the necessary elements of relevant corporate misconduct, causation, reliance and damages incurred.

123 Davis, “The status”, n. 15 above, at pp. 32–4, questions the extent to which the existence of the subordination doctrine influences lending decisions. The High Court of Australia in *Sons of Gwalia* [2007] HCA 1 also expressed doubts as to whether the reliance principle “reflects the reality of modern commercial conditions, where assets and liabilities usually are more significant for creditors than paid-up capital” (para. 5).

124 D Sullivan, “Rules, fairness, and formal justice” (1975) 85 *Ethics* 322–31. Admittedly, however, this is unfair on the remaining shareholders: the CAMAC Report notes that when aggrieved shareholders sue or reach a settlement with the company, the people who indirectly suffer loss are the remaining shareholders, from the market value of their shares or reduced dividends (n. 69 above, at para. 3.3.4). This problem is discussed further below.

125 *Pilcher v Rawlins* (1872) 7 Ch App 259.

### Difficulties with implementing parity

It may be seen from the foregoing that, on the basis of corporate theory and the nature of public policy, there are grounds for considering that the US legislature is content with the alignment of the interests of unsecured creditors and injured investors and might not respond to calls for it to resolve the apparent discord between the principle of mandatory subordination and the effect of a Fair Funds distribution.<sup>126</sup> This may be contrasted with the swift action taken in Australia to enact an unequivocal rule. Many of the concerns voiced relate to the manner in which the SEC or injured investors may adapt their behaviour to maximise their recoveries.

For example, fears have been expressed that the SEC may become aggressive in its pursuit of larger penalties, resulting in the decrease of assets available to general creditors, where the penalties are sought from a company involved in a bankruptcy proceeding.<sup>127</sup> These are reinforced by indications that the SEC has welcomed the Fair Funds provision as an innovation which it can use “to return more funds to investors”.<sup>128</sup> Black relies on financial fraud settlements against four corporate defendants to demonstrate how the SEC’s efforts to create Fair Funds distributions for investors have resulted in an evasion of the disgorgement requirement and the imposition of sizeable penalties.<sup>129</sup> Moreover, the shift towards compensation as a goal of the SEC may have implications for the deterrence objective of securities law enforcement, if the SEC pursues penalties that have a compensatory effect but are inadequate for deterrence, or foregoes the collection of penalties in situations where they cannot be used to compensate investors.<sup>130</sup>

Mass claims by investors to recover damages may also bring about a diminution in the assets available to unsecured creditors, as noted by Callinan J in *Sons of Gwalia*: “It is not difficult to imagine a situation in which claims of a large body of shareholders, perhaps most of them, would dilute the creditors’ rights to a trickle.”<sup>131</sup>

In the context of Australian law, it was noted that class actions and litigation funding might encourage this form of shareholder litigation, also to the detriment of the remaining shareholders.<sup>132</sup> Furthermore, any complications associated with such proceedings would be multiplied in the event of the collapse of a corporate group.<sup>133</sup>

A matter which has received less attention, particularly in the context of the US where the SEC as a regulatory body is empowered to redistribute its bankruptcy recoveries to injured investors, is the extent to which these “sub-distributions” conform to the principles of insolvency distribution. The potential for the SEC, in the context of bankruptcy proceedings, to pursue policies which are not related to the accepted objectives of insolvency law<sup>134</sup> is most starkly reflected against the backdrop of the three possible

<sup>126</sup> Made by scholars including Christensen, “Fair Funds”, n. 26 above.

<sup>127</sup> *Ibid.* p. 370.

<sup>128</sup> SEC, *Report*, n. 92 above, p. 36. See Winship, “Fair Funds”, n. 33 above, p. 1124.

<sup>129</sup> Black, “Should the SEC?”, n. 102 above, p. 331. Namely WorldCom, Time Warner, AIG and Fannie Mae.

<sup>130</sup> Winship, “Fair Funds”, n. 33 above, at p. 1139.

<sup>131</sup> *Sons of Gwalia* [2007] HCA 1, para. 256.

<sup>132</sup> See CAMAC Report, n. 69 above, n. 3.3.4.

<sup>133</sup> M Wyburn, “Pooling as a response to the competing interests in corporate group collapses in Australia” (2010) 19 *International Insolvency Review* 65, p. 72.

<sup>134</sup> Objectives outlined by Goode, *Principles*, n. 12 above, pp. 2–17 *et seq*; Richardson and Mack note that the SEC can establish a plan based on considerations that are not recognised under the US Bankruptcy Code: R G Richardson and J S Mack, “It isn’t what it used to be, but the SEC still protects shareholder interests” (2007) 26(3) *American Bankruptcy Institute Journal* 12, p. 67.

interpretations that are associated with the mention of the *pari passu* principle,<sup>135</sup> which enforces pro rata distribution among unsecured creditors in insolvency. This “equality of distribution” principle has been identified in the opening pages of this paper as operating within the framework of absolute priority in US law, and accordingly may be examined within the setting of more general observations relating to *pari passu* treatment.

The broadest view of the *pari passu* rule is one whereby it connotes the treatment of all unsecured creditors equally and ignores any considerations pertaining to their individual circumstances.<sup>136</sup> This outlook is not represented in the SEC’s actions vis-à-vis Fair Funds because it is empowered to set distribution criteria that are not objective in nature. The courts, recognising the deterrent role of enforcement mechanisms such as disgorgement, have deferred to “the experience and expertise of the SEC” in the line-drawing which inevitably leaves out certain potential claimants.<sup>137</sup> This line-drawing is as relevant for seeing which parties are brought into the distribution process, as well as noting who is left out: as seen in *Official Committee of Unsecured Creditors of WorldCom Inc. v SEC*,<sup>138</sup> shareholders may receive payment in priority to certain classes of creditors in the interests of equalising their respective recoveries. This means that pre-insolvency payments to creditors, which would not otherwise be subject to challenge, may nonetheless provide grounds for excluding them from the SEC’s distribution. Furthermore, since the Fair Funds proceeds may be distributed among “victims of [securities] violations”<sup>139</sup> it is possible for parties who had not acquired an interest in the debtor’s estate as shareholders, but were nonetheless injured by the violations, to enjoy priority over non-defrauded shareholders. This goes to the nature of the rights acquired before bankruptcy<sup>140</sup> and, with respect to personal actions, the upholding of remedies in tort over the contractual rights of creditors and shareholders.

An alternative conception of *pari passu* treatment sees it as denoting no more than pro rata distribution within classes.<sup>141</sup> This is detracted from in the context of Fair Funds insofar as experience has shown that the SEC may choose which parties to exclude in favour of others. In terms of this second interpretation, in the normal bankruptcy hierarchy, non-preferential unsecured creditors would together occupy one class and shareholders another.<sup>142</sup> By contrast, the SEC’s distribution methods permit it to select from either class certain investors to benefit from the Fair Funds proceeds. This would be at the expense of others who properly belong to those classes but who had made a profit on the sale of their securities during the period in which the fraud occurred or recovered more than a given percentage of their entitlements through the sale of their securities.<sup>143</sup> Even though these investors could have qualified as general unsecured creditors or shareholders, they may be barred by the SEC from participation in the Fair Funds distribution for the benefit of the non-profiting or non-recovering unsecured creditors and shareholders. The result is

---

135 Identified by R J Mokal and L C Ho, “The *pari passu* principle in English ancillary proceedings: *Re Home Insurance Company*” (2005) 6 *Insolvency Law and Practice* 207–10, p. 208.

136 Mokal and Ho, “The *pari passu* principle”, n. 135 above; Bridge, “Collectivity”, n. 21 above, para. 1.2; *In re Smith, Knight & Co. ex parte Asbury* (1868) LR 5 Eq 223.

137 *SEC v Wang* (1991) 944 F2d 80, at 88.

138 *Official Committee*, n. 42 above.

139 §308(a) Sarbanes–Oxley Act, 2002 Pub L No 107-204, 116 Stat 745.

140 Goode, *Principles*, n. 12 above, para. 3-02.

141 Mokal and Ho, “*Pari passu* principle”, n. 135 above.

142 *Ibid*; Wood, *Law and Practice*, n. 11 above, para. 1-14.

143 Distributions of this nature accepted as being proper in *SEC v Wang* (1991) 944 F2d 80 and in *Official Committee*, n. 42 above.

therefore of differing treatment of general creditors *inter se* and shareholders among themselves by effecting the dismantling of these recognised classes in insolvency. If we accept that ranking in insolvency is indeed its most important feature, rather than the achievement of equal treatment,<sup>144</sup> in the context of the sub-distributions creditors or shareholders cannot be guided by the prior knowledge that they would ordinarily have of their place within the distribution structure. Thus, their rank (or mere participation in distribution) is not determined with reference to negotiations conducted with the debtor *ex ante*<sup>145</sup> and in accordance with their respective bargains, but in the light of their position at the time of distribution and *relative to one another*. Insofar as account is taken of profits or recoveries already made by the time the SEC comes to disburse Fair Funds proceeds, the ranking is coloured with a moral or ethical element which *pari passu* has been found to lack.<sup>146</sup> This disregards the possibility that at least some of the transactions may have been entered into by the investors in ignorance of the fraud. Even where there is an awareness of the fraud, it might not necessarily act as a check on pre-disgorgement transactions between the debtor and investors: some may prefer to maximise the gains from the sale of their securities than gamble on the uncertainty of the SEC's discretion being exercised in their favour. Thus, rather than producing deterrent effects for irregular or dishonest activities, this form of ranking may be counter-productive for the SEC's pooling of funds.

The entitlement of the SEC to distribute Fair Funds proceeds according to its discretion also sits uneasily with the third facet of *pari passu* treatment, namely the principle of collectivity.<sup>147</sup> The collective nature of insolvency relates to the conservation of the estate to ensure orderly distribution among creditors.<sup>148</sup> Predictably therefore, the number of ordinary unsecured creditors proving claims in the debtor's insolvency determines the size of their respective returns following payment of priority obligations. Collectivity consequently carries a certainty of at least partial recovery for a creditor, with the proportion being dependent upon the number of other parties participating in the sharing of the estate. Conversely, in the disbursement of Fair Funds, it is settled that the standard of fairness and reasonableness permits the SEC to take account of the limited funds available for distribution in deciding which parties to exclude from payment under its plan.<sup>149</sup> Thus, the certainty of participation is absent for investors as the amount available for payment influences the decision on who may benefit from the Fair Funds. The distinction is clear: while for the purposes of collective treatment in insolvency it is sufficient to be accepted as a creditor, qualifying as a victim of a securities violation does not assure enjoyment of a share in Fair Funds.

A gap is therefore apparent between the normal course of an insolvency distribution procedure and the manner in which the SEC fulfils its responsibilities for distribution of the Fair Funds with respect to a company which is now insolvent. The readiness of other jurisdictions to adopt the Fair Funds model may be tempered by the fresh imbalances which parity seems to generate. These are briefly discussed in the concluding section of this paper.

144 J Dalhuisen, *Dalhuisen on Transnational and Comparative Commercial, Financial and Trade Law* 3rd edn (Oxford: Hart 2007), p. 959. See also Mokal and Ho, "Pari passu principle", n. 135 above.

145 As argued by Dalhuisen, *Dalhuisen*, n. 144 above.

146 See, for instance, *Mitchell and another v Buckingham International plc & others* [1983] Ch 1. "Amorality" of *pari passu* also noted by Bridge, "Collectivity", n. 21 above, para. 1.2.

147 Principle outlined in more detail by Mokal and Ho, "Pari passu principle", n. 135 above, p. 208.

148 *Ibid.* Goode, *Principles*, n. 12 above, para. 1-04.

149 *SEC v Wang* (1991) 944 F2d 80, at 87–88. This also occurred in *Official Committee*, n. 42 above. This is despite the fact that the SEC can determine the size of its "estate" insofar as it can take some account of shareholder loss in formulating the size and nature of its penalty: *SEC v WorldCom* 273 F Supp 2d 431.

### Does parity open up new imbalances?

The difficulty of squaring the parity brought about by Fair Funds with prevailing conceptions of the notion of *pari passu* treatment have been highlighted in the preceding section of this paper. Even if it could be aligned with the equality of distribution principle, there are two important respects in which it may be seen as unsettling particular shareholders and creditors.

The first, identified in literature on securities class actions, is the circularity problem.<sup>150</sup> This occurs due to the shifting of wealth from the current shareholders of a corporation, who indirectly bear the costs of any judgment or settlement against it, to the claimant shareholders who acquired shares in the company at the material time.<sup>151</sup> Coffee describes a more complex form of wealth transfer, affecting diversified shareholders, in these terms:

Often shareholders will belong to both the plaintiff class that sues and the residual shareholder class that bears the cost of the litigation. This can result because they purchased stock at times that are both inside and outside the class period, so that they are on both sides of the litigation. Thus, they are effectively making wealth transfers to themselves, in effect shifting money from one pocket to the other, minus the high transaction costs of securities litigation.<sup>152</sup>

Alternatively, if the shareholders of a company are not all similarly diversified, litigation may bring into tension the interests of the “buy and hold” (small undiversified) investors with those of the “in and out” (larger sophisticated) traders.<sup>153</sup> Mitchell has decried the notion of the “innocent shareholder”, portrayed as the rationally apathetic passive investors from whom wealth is transferred in this way. He argues that shareholders’ participation in the affairs of the company ensures the integrity of capital markets and is part of the mechanism by which managerial frauds are deterred.<sup>154</sup> This may be countered with the observation that shareholders of a public corporation usually have little or no voice in the selection of the managers or the way in which they conduct its affairs; large creditors are likely to have much more control, especially as the company slides into insolvency.<sup>155</sup> One might also add that the “shareholder participation” argument does not answer the concerns of individuals who hold shares indirectly through pension funds, unit trusts, or other collective investments.<sup>156</sup> They are not in a position to exert any significant influence over the running of the company.

---

150 J Coffee, “Reforming the securities class action: an essay on deterrence and its implementation” (2006) 106 *Columbia Law Review* 1534; I. Mitchell, “The ‘innocent shareholder’: an essay on compensation and deterrence in securities-class actions” (2009) *Wisconsin Law Review* 243.

151 Coffee, “Reforming”, n. 150 above.

152 *Ibid.* p. 1558.

153 *Ibid.* pp. 1559–60.

154 Mitchell, “Innocent shareholder”, n. 150 above, pp. 291–2.

155 Davis, “The status”, n. 15 above, p. 44. Furthermore, with respect to individual shareholders, the evolution of their role from “shareholder as owner/principal” to “shareholder as investor” with limited participation rights is traced by Jennifer Hill: J Hill “Visions and revisions of the shareholder” (2000) 48 *American Journal of Comparative Law* 39.

156 A recent report on equity and bond ownership in the US found that that there had been a growth in ownership through employer-sponsored retirement plans: *Equity and Bond Ownership in America* (Washington: Investment Company Institute and the Securities Industry and Financial Markets Association 2008).

Secondly, the debate regarding parity creates a danger of viewing all unsecured creditors as contractual creditors, such as lenders and trade suppliers.<sup>157</sup> Parity will also affect creditors who have not bargained for risks on the same basis. While parity with non-shareholder tort creditors may be wholly appropriate on the basis that both types of claim are rooted in involuntary debt, in this context one must also have regard to the interests of creditors, such as the revenue authorities, whose relationship with the debtor company is not derived from a negotiated acceptance of risks. This is of particular significance in countries where fiscal debts no longer enjoy preferential status, such as the UK. Insolvency law reforms aimed at improving the position of unsecured creditors included the abolition of Crown preference in all insolvencies – corporate and personal.<sup>158</sup> A study recently carried out by the Office of Fair Trading found that Her Majesty's Revenue & Customs was owed more than £50,000 in 57 per cent of administrations and on average accounted for 24 per cent of unsecured debt.<sup>159</sup> The justifications for parity may be somewhat undermined, if it results in encroachment on other claims which merit repayment in the wider public interest.

The potential for these distortions to result from an acceptance of parity underlines the importance of clarifying who the “shareholders” and “unsecured creditors” are. That is to say, it is difficult to assess the weight to be given to arguments for parity without knowing whether the actual composition of these two groupings substantiates perceptions of their relative power or vulnerability. No statistical breakdowns could be found regarding the make-up of the unsecured creditor class,<sup>160</sup> but studies of share ownership in the US and Australia respectively reveal a great deal about the nature and extent of share investments in the two countries. It is recorded that in the US in 2008, nearly half of all households owned either equity or bonds.<sup>161</sup> Depending on their age, the primary goals of investors were saving for a home purchase and education (under 40s), saving for retirement (40–64 years) or generating current income (65 years and older).<sup>162</sup> Having long-term investment goals meant that most equity-owning households were not frequent traders, and had not evidenced a pattern of buying and selling in response to the stock market conditions in 2007.<sup>163</sup> These appear to be the buy-and-hold investors described in the wealth transfer problem mentioned above, who indirectly bear the cost of judgments or settlements against the company in favour of shorter-term investors. Furthermore, it was found that a large number of investors had purchased their equities/bonds through professional financial

---

157 For instance, the CAMAC Report, n. 69 above, in Australia considered the implications for corporate financing (domestic and international), trade creditors, and the standing of Australian companies in corporate bond and distressed debt markets, paras 2.4.1–3. Davis, a proponent of parity in the US long before the introduction of Fair Funds, also sees the creditor class as being dominated by large financial institutions “although it includes many comparatively small claimants in the form of trade creditors and individual holders of the debtor’s bonds and debentures”; Davis, “The status”, n. 15 above, p. 29.

158 See para. 2.19 of the government White Paper, *Productivity and Enterprise: Insolvency: A second chance* CM 5234 (London: HMSO/DTI 2001). Abolished via s. 251 of Enterprise Act 2002, amending Sch. 6 of the Insolvency Act 1986 to remove preference for debts due to the Inland Revenue, Customs and Excise, and in respect of social security contributions.

159 Office of Fair Trading, *The Market for Corporate Insolvency Practitioners* (London: Office of Fair Trading/Crown 2010), para. 4.61.

160 The study by the UK Office of Fair Trading states that “[u]nsecured creditors range from larger, repeat unsecured creditors such as Her Majesty’s Revenue & Customs . . . and large landlords (in England & Wales) to customers, trade creditors and employees”; *ibid.* para. 1.13.

161 *Equity and Bond Ownership*, n. 156 above, p. 5.

162 *Ibid.* pp. 27–8.

163 *Ibid.* p. 47.

advisers, rather than through retirement plans at work.<sup>164</sup> Contrary to the perception of modern shareholders being resourceful and more knowledgeable about the risks attached to different share offerings,<sup>165</sup> ownership of equities through professional advisers was predominant across all investor groups, regardless of age, education level, household income, etc.<sup>166</sup> Most households that acquired equities through professional advisers were shown to regularly rely on their advisers for investment advice and guidance.<sup>167</sup> Likewise, in Australia 41 per cent of the adult population owned shares in 2008, the main reasons for investing being “to make money”; accumulate wealth; for long-term capital gains; and to obtain higher returns.<sup>168</sup> There was no marked pattern of frequent buying and selling; between 2002 and 2008 the average value of share trades did not exceed 11 per cent of the average value of monies invested.<sup>169</sup> Australian investors could be distinguished from those in the US by their use of the internet to buy shares, and the division of share-owners into segments according to their level of knowledge/skill and passion for investing.<sup>170</sup> A sharp contrast may be drawn between the two countries and the UK where individual share ownership levels have declined.<sup>171</sup>

The recognition that a significant number of investors are private individuals seeking to raise funds to pay for their homes, make provision for education or secure their retirement<sup>172</sup> therefore adds another dimension to this debate. These parties may be deemed to be in a comparable position to that of unsecured creditors, in that they are in truth dealing with the company as outsiders, with similar limitations in their knowledge of its business and matching expectations to be supplied with accurate information. The studies detailing their long-term outlook on investment, infrequent trading activity, and limited self-reliance in transacting on the market, indicate that their insight into the risks attached to their investments is not as keen as it may be deemed to be.

## Conclusion

This paper has sought to demonstrate how, as a matter of principle, grounds exist for accepting parity as a response to modern conditions. Nevertheless, it is clear that the manner and consequences of implementing such a policy require careful analysis. In

---

164 *Equity and Bond Ownership*, n. 156 above, p. 37.

165 See text accompanying nn. 75–7 above.

166 *Equity and Bond Ownership*, n. 156 above, p. 45.

167 69% of these equity/bond owners “always” or “sometimes” consult their advisers when making investment decisions: *ibid.* p. 41.

168 ASX, 2008 *Australian Share Ownership Study* (Sydney: Australian Securities Exchange 2009), pp. 3–15.

169 *Ibid.* p. 18.

170 56% of investors bought shares through an online broker in 2008 (*ibid.* p. 20), compared with the US where the least frequently-mentioned use of the internet was to buy or sell stocks/bonds (see *Equity and Bond Ownership*, n. 156 above, p. 37) – investors used it mainly to access financial accounts or get financial news. As regards segmentation, ASX 2008 classified investors as “confident”, “aspirational”, “diligent” or “delegator”.

171 10.2% of the value of all UK ordinary shares quoted on the London Stock Exchange is held by individuals, compared with 54% in 1963 and 14.1% in 2001: see Office for National Statistics, *Share Ownership Survey* (London: Crown 2010). In terms of household percentage, 34.2% of UK households hold shares (including UK shares, stocks and shares investment savings accounts, employee shares and share options, and overseas shares): Office for National Statistics, *Wealth in Great Britain: Main results from the wealth and assets survey 2006/08* (London: Crown 2009).

172 United States SEC, *The Investor's Advocate: How the SEC protects investors, maintains market integrity, and facilitates capital formation*, available at <http://www.sec.gov/about/whatwedo.shtml>. Some investors may be former employees of companies who have received benefits in the form of shares: See A Hill, S McNulty and E Wine, “A poor retirement: the bankruptcy of Enron has brought into uncomfortably sharp focus broader doubts about the way that US employees invest for their old age”, *Financial Times*, 12 December 2001.

practical terms, it may prove to be a token shift, given the fact that unsecured creditors often make no recoveries on their claims.<sup>173</sup> Furthermore, distributions aimed at compensating injured investors will be difficult to reconcile with this long-standing interpretation of the statutory *pari passu* rule:

. . . everybody shall be paid *pari passu*, but that means everybody after the winding-up has commenced. It does not mean that the Court shall look into past transactions, and equalise all the creditors by making good to those who have not received anything a sum of money equal to that which other creditors have received. It takes them exactly as it finds them, and divides the assets amongst the creditors, paying them their dividend on their debts as they then exist.<sup>174</sup>

The US experience shows that the policies underlying investor protection, such as deterrence and compensation, and a regulatory body's power to enforce them, can sit uneasily with the understanding of "equality of distribution" in an insolvency context. In the UK, the *Davies Review of Issuer Liability* concluded that the question of subordinating defrauded shareholder claims needed further investigation, noting that it raised important general issues about the nature of equity investment in companies and the role of legal capital.<sup>175</sup> The growing correspondence between the positions of shareholders and unsecured creditors highlighted in this paper should not convey the impression that the incorporation of defrauded shareholder interests into the unsecured creditor class can be achieved through a simple grafting-on process. It carries implications for the essence of the insolvency distribution regime, and should accordingly be approached with care.

---

173 Noted by Gengatharen: R Gengatharen, "Sons of Gwalia: defrauded shareholders claims in insolvency" (2008) 17 *International Insolvency Review* 1, at p. 7. See also R J Mokal, *Corporate Insolvency Law: Theory and application* (Oxford: OUP 2005), ch. 4. The impact of parity on the cost of administering the estate may in fact further diminish their recovery levels: Hargovan and Harris, "Sons of Gwalia", n. 78 above, consider the implications of parity for the efficient handling of claims in insolvency.

174 *In re Smith, Knight & Co. ex parte Ashbury* (1868) LR Eq 223, at 226 (per Lord Romilly MR).

175 P Davies QC, *Davies Review of Issuer Liability: Final report* (Norwich: Stationery Office 2007), paras 61–2. It was recommended that the UK government should consider adopting the Australian CAMAC Report, n. 69 above, as part of any future policy developments in this area, but one wonders whether this recommendation would be maintained given the Australian government's advice to pursue explicit statutory subordination contrary to CAMAC's advice.