

The Deep Veins of the Sons of Gwalia Litigation

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This paper engages in a doctrinal analysis of historical precedent on aggrieved shareholder claims in the UK. It does so in order to expose the basis for the judgment of the House of Lords in the foundational case of Houldsworth v City of Glasgow Bank (1880) 5 App Cas 317, which held in cases involving fraudulent or misleading behaviour inducing share purchase that it would be inconsistent with a shareholder's membership contract to 'claim back' amounts originally committed to the company for the pursuit of its business objects and the payment of its liabilities. This analysis will demonstrate that the judgments in Houldsworth (which have prevented shareholders ranking on par with unsecured creditors up until the determination of the High Court in Sons of Gwalia Ltd (admin apptd) v Margaretic (2007) HCA 1) ignored relevant legislation in the form of s 38(7) of the Companies Act 1862 UK which was specifically applicable to cases involving aggrieved shareholder claims, instead relying on principles drawn from the law of partnerships to decide the case. While it is submitted that the High Court was justified in choosing not to apply Houldsworth, the rule may still prove good law in certain circumstances. Having been the subject of a recent Corporations and Markets Advisory Committee review the issue of aggrieved shareholder claims is current as ever, though the veins of the problem run rather deep in the history of Australian and UK corporations law. This paper seeks to illustrate the value of a deeper understanding of the history of such claims to making informed policy decisions going forward. The paper argues that the rule in Houldsworth's case should be abrogated by legislation in order to provide certainty in this technical area of the law.

On 18 August 2004 Luka Margaretic bought 20,000 shares in Sons of Gwalia (SoG), a gold mining company based in Western Australia, on the Australian Securities Exchange (ASX). Just over a week and a half later on 29 August, directors of the company appointed administrators on the belief that the company was or was likely to become insolvent under s 436A(1). The company entered into a deed of company arrangement under Div 10 of Pt 5.3A of the *Corporations Act 2001* (Cth), under which administrators were to distribute SoG's remaining assets in the same order in which it would if it were being wound up.

It has since emerged that the company's Chief Financial Officer had been engaging in unauthorised gold hedging and foreign exchange trading activities from the mid 1990's. Spectacular losses were made and housed in off-balance sheet accounts to the point that 'directors considered that the extent of the potential losses threatened the company's existence',¹ yet no public announcements were made alerting the market to this information. Apparently, according to the administrator's report, SoG did not take an opportunity to close out commitments to its options contracts in August 1999 at a cost of \$74 million. Instead, with a rising gold price and more call than put options over its gold reserves, 'the company's treasury operations got out of control and the company appeared to have been riding a train with no brakes towards a cliff. The cliff took a long time to arrive – August 2004, when the company collapsed owing about \$1 billion'.²

In *Sons of Gwalia Ltd (admin apptd) v Margaretic*,³ the High Court controversially chose not to apply a rule said to be germane to aggrieved shareholder claims in cases of insolvency involving fraudulent and misleading behaviour known as the rule in *Houldsworth's case*.⁴ The rule said to have been developed in *Houldsworth v City of Glasgow Bank*⁵ had up until the High Court's decision been used to interpret legislative provisions concerning shareholder claims, preventing shareholders from ranking on par

with unsecured creditors for over a century and resulting in problematic determinations in the context of modern developed markets. The case established that in cases involving fraudulent or misleading behaviour inducing share purchase it would be inconsistent with a shareholder's membership contract to 'claim back' amounts originally committed to the company for the pursuit of its business objects and the payment of its liabilities. While it is submitted the High Court was justified in choosing not to apply the rule in *Houldsworth's case* and thus allowing shareholders to claim as unsecured creditors, the rule may still prove good law in certain circumstances.⁶

This paper engages in a doctrinal analysis of historical precedent on defrauded shareholder claims in the UK to demonstrate that the decision in *Houldsworth* and subsequent interpretation and application of the 'rule' therein suffer from deep flaws which have led to unjust determinations in view of the regulatory matrix surrounding the operation of Australian financial markets and the protections afforded to market participants. Part one will analyse two cases preceding *Houldsworth*, *Oakes v Turquand*⁷ and *Tennent v City of Glasgow Bank*⁸, which set the scene for Houldsworth's claim and had a direct bearing on the outcome of the case. In part two, an analysis of *Houldsworth* proper will be undertaken. On the basis of this analysis it will be argued that it is necessary to put the current uncertainty surrounding the applicability of *Houldsworth* in Australia beyond doubt through legislative abrogation of the rule in *Houldsworth's case*. The purpose of this paper is to advocate law reform and to demonstrate that an understanding of the history of defrauded shareholder claims and how creditors came to be accorded priority ranking in such circumstances is essential to making informed decisions about the future direction of legislation in this area of the law.

Part 1. Houldsworth's Lineage

Despite its long history and its application in several UK and Australian cases, the High Court in *Sons of Gwalia* chose not to apply authority in the form of *Houldsworth v City of Glasgow Bank*⁹ in deciding whether aggrieved shareholders should rank equally with unsecured creditors in cases of insolvency involving misleading and deceptive behaviour. To appreciate why, it is necessary to understand the approach taken by the House of Lords in that case. An accurate understanding of the decision in *Houldsworth* however necessitates an inquiry into its lineage. If *Houldsworth* was born in 1880,¹⁰ then he was conceived by two primary decisions, *Oakes v Turquand*¹¹ and *Tennent v City of Glasgow Bank*.¹²

The question concerning shareholder rights on insolvency which the House of Lords faced in Oakes' case was the first of its kind to be decided after the enactment of the *Companies Act 1862* UK, the progenitor of Australia's *Corporations Act 2001* (Cth). Upon the bankruptcy of *Overend, Gurney, & Co. Limited*, a company providing bill broking and money dealing services, two shareholders alleged that they were induced to take shares in the company by way of false and fraudulent representations made by the company in a prospectus. The shareholders, Oakes, who subscribed for an initial offering of shares in Overend directly from the company and Peek, a transferee shareholder who bought his shares on the open market, sought to have their names removed from the register of the list of contributories on Overend's books. The Law Lords focused their attention on Oakes' case for if he was not able to succeed in being relieved from liability then Peek could have no hope of the same. This appears to have been because causality of the misleading nature of the prospectus could be established for a subscribing though not a transferee shareholder.¹³

All of the Law Lords recognised the fraudulent and deceptive character of the prospectus, which omitted important information that would otherwise have enabled an accurate assessment to be made by potential investors of the financial future of the company. The Lord Chancellor went so far as to say that if the real circumstances facing the company had been disclosed ‘it is not very probable that any company founded upon it would have been formed’,¹⁴ indicating that the fraud practiced was to so great a degree that there was no foundation at all on which to base the company.

Nevertheless, basing their decisions on similar grounds adverse to Oakes in view of the difference between void and voidable contracts, principles of partnership law and the exact nature of the changes which the 1862 Act had on the dynamics of creditor satisfaction in the event of insolvency, the House of Lords rejected Oakes case. Most importantly, on Oakes’ contention that due to the fraudulent conduct of the directors that he never really held a share and was therefore never really a member, the Court was in no doubt: Although the purchase contract was induced by fraudulent activity, the contract itself would stand until Oakes chose to rescind it. The Lord Chancellor quoted *Clarke v Dickson* in support: ‘a contract induced by fraud is not void, but voidable only at the option of the party defrauded’.¹⁵ Since Overend was insolvent and *restitutio in integrum* was impossible, Oakes was left without the remedy of rescission.

Great emphasis came to be placed by the Lord Chancellor and Lord Cranworth on Lord Campbell’s judgment in *Henderson v The Royal British Bank*,¹⁶ a case decided before the changes in the *Companies Act 1862* UK took effect:

It would be monstrous to say, he having become *a partner and a shareholder, and having held himself out to the world as such*, and having so remained until the concern stopped payment, could by repudiating the shares on the ground that he had been defrauded, make himself no longer a shareholder, and thus get rid of his liability to the creditors of the Bank, who had given credit to it on the faith that he was a shareholder.¹⁷

The Lord Chancellor saw the reasoning in *Henderson’s case* as constituting an authority of ‘great weight’¹⁸ against Oakes and would apply unless the new *Companies Act 1862* UK changed the relationship between the company and its members.

The Lord Chancellor and Lord Cranworth agreed that the Act intended to put shareholders whose names were on the register in the same position towards creditors

as persons engaged in an ordinary partnership, or persons trading formerly under the Acts of 1844. In neither of those cases would it have been an answer to a creditor that the person sought to be charged had been induced by fraud to become a partner or a shareholder, and *I see no reason whatever for adopting any other principle here*.¹⁹

Significantly for the development of the law in this area, Lord Cranworth directly applied principles of partnership law to a determination of a case concerning a limited liability company. Indeed his Lordship saw no reason to question the judiciary’s view of the company form, despite the changes in legislation noted above.

Lord Colonsay stated that the Appellant’s argument proceeded on an ‘erroneous view of the nature of these companies, and of the relative positions of the creditors and the members’.²⁰ His Lordship stated that although the ‘efforts of the Legislature were directed towards giving these companies a separate *persona*’ through the 1862 Act, they did not confer upon them ‘all the attributes of proper corporations without qualification ... The companies were said to be incorporated, but they were only incorporated to certain effects –

they were *quasi-corporations*'.²¹ In his view then, the statutory beast created by the 1862 Act was in fact still under construction – 'the course of legislation was to rear up the company into a separate persona ... but without conferring on it in an unqualified manner all the attributes of a perfect corporation'.²²

With the decision in *Salomon v Salomon & Co.*²³ thirty years of judicial development away, Lord Colonsay turned to principles relating to the partnership form. His Lordship stated that although Oakes may have been induced into the contract for shares by fraudulent behaviour, that the relevant question on the statute was whether he had *agreed* to become a shareholder as per s 23. Holding Oakes to have done so, it followed that the contract into which he had entered was not void, but only voidable. In turn, this meant that the contract was valid until rescinded as the case was one where the rights of third parties – that is, creditors – 'intervene'.²⁴

Despite the fraud practiced on him, upon insolvency creditors found Oakes with his name on the register of members, a liability he would otherwise have been able to escape through rescission if Overend was a going concern. Since Oakes was a member as defined by s 23 of the 1862 Act in that he had simply *agreed* to become a one, this apparently meant that he was liable to contribute to the debts of the company upon insolvency on a shallow reading of the 1862 Act. Shallow, for this decision was made without any inquiry into s 38(7), a provision directly applicable to the case which states:

No sum due to any member of a company, in his character of a member, by way of dividends, profits, or otherwise, shall be deemed to be a debt of the company, payable to such member in a case of competition between himself and any other creditor not being a member of the company.²⁵

The relevant question pertaining to this section would seem to be whether the claim was made in a member's character of a member, not simply whether they were a member according to s 23. This would presumably necessitate an inquiry into the nature of share ownership and membership of companies, as well as an interrogation of the meaning of the term 'otherwise' in the provision.

The Law Lords had a view of the company form and insolvency largely determined by principles relating to the partnership form, where upon insolvency the only rights exercisable by a defrauded partner were against their fellow partners, who were in no way able to lessen their own obligation towards creditors. Through Lord Chancellor Chelmsford and Lord Cranworth's affirmation of the reasoning in *Henderson's case*, and by express comment by Lord Colonsay, the idea of 'holding out' to creditors thus became a feature in the consideration of claims by members against companies in liquidation. The partnership analogy applied to a new breed of business owners in shareholders gave vital support to the consideration of the interests of creditors in the reasoning of the court, as shown through the endorsement of *Henderson's case*. In the absence of the partnership law lens which drove the court to apprehend shareholders of the company as partners in it, responsible for all debts and liabilities whether incurred legitimately or fraudulently, the prominence given to creditor interests in cases of insolvency involving fraudulent activity arguably would not survive on its own.

The Question in Tennent

Oakes wished to have his name removed from the register when winding-up and administration was underway. The question in Tennent's case thirteen years later and just prior to *Houldsworth* was whether a contract for shares could be rescinded up until the time of the actual commencement of the winding-up, at a time when shareholders knew the company to be insolvent, yet before any creditor had instituted the actual winding-up.

Lord Chancellor Earl Cairns, who also led the decision in *Houldsworth* and with whom Lords Hatherley, Selborne and Gordon concurred, affirmed the conclusion reached in *Oakes* that a shareholder could not rescind the purchase contract upon insolvency, irrespective of any fraud which induced entry into the contract. Accepting that Tennent would have succeeded in such an action had the bank been a going concern, Earl Cairns nonetheless held that he could not do so upon insolvency. His Lordship based his decision on principles relating to void and voidable contracts, and the principle expressed by the Lord President in the case at first instance that ‘the option to void the contract is barred where innocent third parties have, in reliance on the fraudulent contract, acquired rights which would be defeated by its rescission’.²⁶

In his reasons Earl Cairns looked to the law of partnerships for enlightenment on the position of Tennent in the circumstances. As noted above, in ordinary partnerships it was not possible for a partner to repudiate the partnership without being bound to satisfy its liabilities, whether the partnership was solvent or insolvent. Although fraud may have been a reason for relief against his partners, it was held that it was not grounds for escaping liabilities owed to external parties in the form of creditors. While the principle differed in reality for shareholders in companies who were able to escape liability to creditors via the sale of their shares while the company remained a going concern, and at a time when ‘no creditor has any specific right to retain the individual liability of any particular shareholder’,²⁷ according to the Lord Chancellor,

[t]he repudiation of shares which, while the company was solvent, would not or need not have inflicted any injury upon creditors must now of necessity inflict serious injury on creditors. I should, therefore, be disposed in any case to hesitate before admitting that, after a company has become insolvent and stopped payment, whether a winding-up has commenced or not, a rescission of a contract to take shares could be permitted *as against creditors*.²⁸

This meant that shareholders would have to be bound in the same way partners were in insolvency situations. Earl Cairns was thus of the same mind as Lord Cranworth in *Oakes*, developing the idea of a winding-up simply as a method for the enforcement of payment to creditors. For this reason, Earl Cairns was averse to allowing a member to rescind a contract for shares after the company had stopped payment, and dismissed the appeal.

Tennent established that rescission was impossible upon insolvency, that is, before formal winding-up procedures had begun. The underlying view of the company and of shareholding in *Tennent* was the same as that expressed in *Oakes*, although a more forceful appeal was made to the interests of creditors in the situation, who by this stage had taken on the position of innocent third party purchasers in the law as it stood relating to claims for fraudulent transfers of property.

In analysing these decisions, it is important to appreciate the fact that the House of Lords was working on a completely different conceptualisation of the company form to that apparent today. Although the House of Lords in *Oakes* expressly discussed the reasons for the development of the *Companies Act 1862* UK, the Law Lords nonetheless applied principles which appear ill suited to the nature of the corporate form established by that piece of legislation. The reason for this was the perception of the company form simply as a new incarnation of the partnership, and as noted in Lord Colonsay’s judgment, one which was not to be seen as a separate entity of itself as yet.²⁹

Part 2. The Inevitable Damages Claim and the Development of the Rule in Houldsworth

In February 1877 Arthur Hooton Houldsworth bought 4000 pounds worth of stock from the City of Glasgow Bank, an unlimited liability company. In October 1878 the bank went into liquidation. As a member Houldsworth's name was placed on the list of contributories and he was called upon to pay 20,000 pounds in calls. A month later in December, Houldsworth brought an action for damages against the liquidators on the grounds that he was induced by the manager and directors of the bank to purchase the shares in the company by way of fraudulent misrepresentations. He sought to recover the value of the purchase price of the shares, the amount he had already paid in calls, and a further amount to cover him for anticipated estimated future calls. The Court of Session in Scotland found that although fraudulent misrepresentations were made,³⁰ that there was nonetheless no success to be had against the liquidators for such sums on insolvency. This was based on House of Lords precedent in *Addie v The Western Bank of Scotland*,³¹ which held that a company could not be sued for the actions of its agents, and that defrauded shareholders would have to pursue directors personally if they were to recover damages.

On appeal to the House of Lords, Lord Chancellor Earl Cairns began his judgment by confirming that Houldsworth could have rescinded his contract of subscription and recovered his expended amounts while the bank was a going concern. Since the winding-up of the bank had begun however, by virtue of *Oakes* and *Tennent* Houldsworth was unable to rescind his subscription contract. The practical effect of this inability to remove himself from the list of contributories was that 'he must remain as liquidation found him, a *partner* in the bank and a contributory as such'.³² Confirming the view he reached in *Tennent*, implicit in Earl Cairns' reasons was his belief that immediately upon insolvency, company assets became the property of creditors, for whom the liquidators act.

Foreshadowing the issue considered by the High Court in *Sons of Gwalia*, the central question for Earl Cairns was whether a shareholder could retain ownership of shares, thus remaining a member of the company, and sue the company at the same time for fraudulent inducement. Since the purchase of chattels or goods on fraudulent misrepresentation was remediable under the common law, Earl Cairns asked rhetorically whether this would also be the case for shares in a partnership or a company? His response is seminal, and deserves to be quoted in full:

We are accustomed to use language as to such a sale and purchase as if the thing bought or sold were goods or chattels, but this it certainly is not. The contract which is made is a contract by which the person called the buyer agrees to enter into a partnership already formed and going, taking his share of past liabilities, and his chance of future profits or losses. He has not bought any chattel or piece of property for himself; he has merged himself in a society, to the property of which he has agreed to contribute, and the property of which, including his own contributions, he has agreed shall be used and applied in a particular way and in no other way. Does, then, the principle which in the case of a chattel admits of an action for damages, apply to the case of a partnership contract such as I have described?³³

The Lord Chancellor's additional rhetorical in the last line seems to go some way to answering his first: He saw the purchase of what moderns would simply call 'shares', items of personal property, as a 'partnership contract'. A partnership contract is much more than a simple good or chattel, it represents a contractual relationship which consists of rights and obligations in respect of the business to which that contract relates.³⁴ In this case the

property of the company to which Houldsworth contributed his own funds as a partner along with others, was to be used for the business of banking in which the company was involved (including the satisfaction of creditor claims on insolvency), not to satisfy the claims of members, and this is why principles relating to ordinary property would not apply.

The depth of the nature of share ownership expressed by Earl Cairns was based on the statutory contract made between members and their company. Through this statutory contract Houldsworth would be entitled to a proportion of the property of the company, depending on the proportion of his share ownership. Earl Cairns held that '[t]his is the contract, and *the only contract*, made between him and his partners, and it is only through this contract, and through the correlative contract of his partners with him, that any liability of him or them can be enforced'.³⁵ It was therefore the statutory contract which held the abstraction of the company together and was to be upheld at all costs, even against the concern of innocent parties fraudulently induced into the fray. Such reasoning effectively ignored the fact that the contract for the actual subscription or purchase of shares and any fraudulent behaviour involved in their sale comes prior to entry into the statutory contract with the company and other members.

Nevertheless, focussing on the statutory contract Earl Cairns concluded that among the debts and liabilities of the company, the allowance of a member's claim for damages, with the effect that the company 'shall pay the new partner damages *for a fraud committed on himself by the company, that is, by himself and his co-partners* ... cannot be intended to be included'.³⁶ This would offend the statutory contract which required amounts to be paid to the company for use in its business, which in the event of profitable trading would result in a return in proportion to the contribution of the member, yet which in the event of a loss would result in the member contributing to the debts and liabilities of the company in proportion to his contribution, as this was an unlimited liability company.³⁷

In attempting to reinstate himself to his original position pre-share purchase, Earl Cairns saw Houldsworth as bringing his claim as a shareholder and therefore, as inconsistent with the statutory contract. This apprehension of the situation entailed a disavowal of the possibility that Houldsworth might have been making his claim as an average tort victim for phenomena which occurred prior to and during his entry into the contract to which he was being held. This could be seen in part to be due to Earl Cairns' failure to give proper regard to the purchase contract. Had he done so, he may have perceived that the claim was really brought outside of the simple fact that he was still a shareholder when he made the claim, as the fraud complained of was practiced upon him in order to induce him into purchase, before he committed his subscription monies in order to be entered into the register of members and made a party to the statutory contract.

Due to this ignorance of the purchase contract and the supreme importance placed on the statutory contract holding the new business combination together Earl Cairns saw Houldsworth's actions as inconsistent with the statutory contract he was ensconced in, and thus trying to 'approve and reprobate'³⁸ at the same time. It appears Earl Cairns and those before him had trouble setting these two contradictory notions apart from within the one person when the claim related broadly to the member's shareholding. This was probably reinforced by his partnership view of shareholding in the company form, which made it difficult to differentiate members from the company they were members of when claims were made. The Lord Chancellor concluded by declaring that 'on principle, irrespective of authority, the decision of the Court of Session was right',³⁹ thus dismissing the appeal.

Lord Selborne began his judgment by discussing the law of agency and focussing on *Addie's case* before stating that '[t]his is *not a case of parties at arm's length with each other* ... and which may be redressed by damages without any unjust or inconsistent consequences'.⁴⁰ In saying this, his Lordship implicitly chose not to separate out

Houldsworth's two positions in the situation, as a tort victim prior to and at least during contract formation, and a member and a victim afterwards. Indeed, he said of Houldsworth's position, that 'here it is impossible to separate the matter of the pursuer's claim from his status as a corporator, unless that status can be put an end to by rescinding the contract which brought him into it'.⁴¹

As did Earl Cairns, Lord Selborne saw Houldsworth's damages claim for the share due from him in contribution to the debts and liabilities of the company as being inconsistent with the contract he had entered into: '[I]t is of the essence of the contract between the shareholders (as long as it remains unrescinded) that they should all contribute equally to the payment of all the company's debts and liabilities'.⁴² Lord Colonsay's view of the company form in *Oakes* thus continued to hold sway here as confirmed by Lord Selborne's comment that 'such an action of damages is really not against the corporation as an aggregate body, but is against all the members of it except one, viz, the pursuer; it is to throw upon them the pursuer's share of the company's debts and liabilities',⁴³ thus choosing not to separate the existence of the member from the company they constituted for the purposes of the claim. From this perspective, Lord Selborne saw rescission as the only remedy available to Houldsworth, and 'the only way in which the company could *justly* be made answerable for a fraud of this kind'.⁴⁴ Due to the fact the option to rescind had lapsed upon insolvency, Lord Selborne also dismissed the appeal.

Beginning where Lord Selborne concluded, Lord Hatherley stated that since *restitutio in integrum* was not possible, that the contract must remain in force. Accordingly, his Lordship also saw the contract as a partnership contract, a partnership from which Houldsworth did not discharge himself: 'It appears to me to be fatal to the Appellant's right to the relief he asks that he is still, or was at the date of the liquidation a shareholder in the company against which he asks it'.⁴⁵ The reason for this was that by becoming a shareholder, Houldsworth was entitled to profits made and responsible for losses and liabilities incurred in proportion to his shareholding. This meant that if Houldsworth's arguments were correct, according to Lord Hatherley such liabilities may include debts 'due to himself in respect of the damage sustained by him through the wrongful act of the company in inducing him by misrepresentation to place himself on the list of shareholders'.⁴⁶ Since Houldsworth was not the only shareholder in this situation, Lord Hatherley raised another consideration, that allowing this appeal would lead to an infinite regress whereby Houldsworth would have to bear a share of the damages of other shareholders who were induced into purchase on the same basis.⁴⁷

Lord Hatherley thus chose to see Houldsworth's claim as being inconsistent with the membership contract he entered into, in other words that there was no other relationship or link through which he could claim against the company. The Law Lords chose not to place much emphasis on the fact that such shareholders did not have much of a choice, indeed, going by their conceptualisation of the issue there were really no other conclusions open to them in insolvency cases. Lord Hatherley concluded by writing off Houldsworth's claim on the basis of his having had the misfortune of employing a 'dishonest agent'.⁴⁸ Since he missed the opportunity to rescind when *restitutio in integrum* was possible, Houldsworth missed the chance to do away with the liabilities which arose from becoming involved with a dishonest agent. Because of what had happened in between the time of his purchase of the shares and the insolvency of the company he was unable to rescind in time, though if he had his name stricken off the register then he could have stood 'in the position of a stranger with reference to misrepresentations made by agents of the company'.⁴⁹ As such, the very fact of continued membership served to prevent him from bringing a claim in relation to his shareholding from any basis other than his status as a shareholder.

For Lord Blackburn, since the differences in fact between Houldsworth's claim and precedent authority in *Addie's Case* were not significant enough to cause a distinction in

law, the issue was ruled by that decision. Lord Blackburn stated of the ‘very peculiar’ contract to take shares in a company that

the contract equally is in substance an agreement with the company to become a *partner* in the company on the terms that the *partner* shall, in common with all his *co-partners* for the time being, contribute to make good all liabilities of the *co-partnership* as if this incoming partner had been a member of the *partnership* from the beginning.⁵⁰

He further stated that although ‘the deceived party may rescind the contract and demand restitution, he can only do so on the terms that he himself makes restitution’.⁵¹ Being impossible for Houldsworth to make restitution, it became impossible to rescind, leading Lord Blackburn to reject the appeal.

When a Shareholder is Not Quite a Shareholder

In view of the authority of the principles established in *Oakes* and reaffirmed in *Tennent*, since rescission was precluded upon insolvency, Houldsworth sought an untested avenue for redress, and decided to sue the company for damages. Because the action was framed in this way, the question as to the ability of a member to sue whilst retaining ownership of shares became the determinative one, as it appeared to contravene the statutory contract and a shareholder’s responsibilities to their fellow shareholders who constituted the abstraction of the company.

Earl Cairns framed the issue by stating that it was impossible to achieve what Houldsworth wanted to while the company was a going concern, and therefore should not be possible on insolvency either. It is not readily apparent why Earl Cairns was willing to treat the company form and shareholder relations to it differently in one instance, that is, after insolvency has been established (where it is seen in his reasons the idea that a fundamental shift in the weight of interests had occurred in favour of creditors) yet say that ‘he must also have had a right before the winding-up to have remained a partner and also then to have brought an action for damages’.⁵² Earl Cairns himself stated that the nature of the company on insolvency was fundamentally altered; should such an alteration for the benefit of a defrauded shareholder also not take place when the shareholder had no opportunity to rescind on insolvency? Unfortunately for Houldsworth, the holding out doctrine established through prior reliance on *Henderson’s case* in *Oakes* forestalled this avenue of relief.

Nevertheless, Earl Cairns found that because shares at that time were considered more than simple goods and chattels and represented a partnership contract, that the meaning of this contract would preclude a company from paying debts and liabilities due to a partner for fraud committed on himself by the company, that is ‘by himself and his co-partners’.⁵³ Such payments were not seen as legitimate uses of the funds originally contributed, which were to be ‘used and applied in a particular way and no other way’.⁵⁴ What has come to be known as the ‘inconsistency with contract’ argument is a result of the choice to conflate the identity of the company with its members, a reading produced by a myopic focus on the statutory contract and principles relating to partnership law. The flipside of the refusal to see the claim as being brought outside of a shareholder’s membership due to the fact they retained their shares in such cases is the idea that the company owed members no duties bar those specified in the statutory contract. This served to allocate the risk of fraudulent behaviour to shareholders who chose to invest in the company, just as a partner was responsible for wrongs committed by their partners in the name of the partnership.

Since the fraud would now be recognised as a wrong committed by a separate legal entity upon a shareholder by virtue of *Salomon*, and not by a member upon himself, the argument of the inconsistency of making a claim with the statutory contract must fall. An important fact which was overlooked in this milieu was that Houldsworth was not a ‘co-partner’ at the time the original fraudulent activity took place which induced him into the subscription contract, but merely a prospective member. As such, the wrong was committed against him outside either contract, which crystallised upon subscription, making him the average tort victim of an organisation which was of a different type to the partnership form.

Lord Selborne made the same conflation Earl Cairns did, stating that because Houldsworth and the company were not at arms length from each other, that damages could not effect an equitable remedy without unjust or inconsistent results. His failure to separate out Houldsworth’s position as a tort victim from his status as a shareholder, seeing his relationship to the company only through the statutory contract, meant that he saw an award for Houldsworth as inconsistent with the contract entered into with other shareholders to contribute equally to payment of all debts and liabilities of the company. The basis for such a holding on principles of partnership law is unmistakable. Because rescission was the only remedy available, and since this was impossible due to the lapse of the opportunity to rescind now the company was insolvent and *restitutio in integrum* was impossible, the contract remained in force.

While Lord Hatherley also agreed with this idea, he was nonetheless more forthright in his characterisation of the contract as a partnership⁵⁵ from which Houldsworth did not discharge himself. The other basis for Lord Hatherley’s decision was the vicious circle argument, which could only really be seen to apply to unlimited companies, where shareholders would have to continuously contribute to the debts of the organisation in proportion to their shareholding. This was in contrast to limited liability shares which set a limit to the amount which was to be contributed by shareholders to the initial subscription or purchase price. Justifying his position with reference to personal responsibility for decisions in risky markets by reference to the ‘misfortune’ of having employed a dishonest agent, Lord Hatherley concluded by drawing attention to authority which suggested that rescission would mean Houldsworth could be treated as a stranger to the company. This confirms the observation made earlier, that it was only due to the perception of members *as* the company that any issue arising around that relationship was governed by the statutory contract, preventing Houldsworth from being seen in any other capacity. With the recognition of the corporate veil and separate legal existence of the corporation in *Salomon*, this rationale and all it supports must fall.

Despite its having been said that ‘the four individual speeches of their Lordships, unanimously dismissing the appeal, lack an altogether common thread’,⁵⁶ the analysis above has shown that there is at least one significant thread holding this judgment together: The choice to focus on the statutory contract, the resulting inconsistency of a member’s claim against that contract, and therefore the perception of the company as not owing any duty to shareholders for claims related to their shareholding. This appears to have been based on the House of Lords’ view of shareholders *as* the company, which arose from its apprehension of the case through a partnership law lens. Because the claim related to his shareholding, by virtue of the very fact that *Houldsworth* was still in possession of his shares, no duty would be owed to him by the company. Although directors would personally owe shareholders like Houldsworth a duty and could be pursued as individuals, the assets of the company itself could not.

The apprehension of the corporate form through the prism of partnership law would have thrown Houldsworth’s claim into an altogether familiar light at the time, that of a partner on a quest to absolve himself from responsibility of the actions of the partnership and his co-partners. The Law Lords in *Houldsworth* demonstrably had the same view of the

corporation as Lord Colonsay and the House of Lords in *Oakes*, in that it was not to be seen as a proper corporation, rather as a quasi corporation and thus as not having fully shed its partnership skin. As a *partner*, Houldsworth could not be absolved from his debts under the statutory contract regulating his relationship with his fellow members, which specified they would pay debts and liabilities as and when due. Despite the dubious foundation of this thread in partnership law principles, the thread and its result, the retention of remaining capital for creditors, have become the primary reasons why shareholders have not been able to claim damages from a company fraudulently inducing share purchase for nearly one and a half centuries. While several difficulties have arisen in the interpretation and application of *Houldsworth*, the fact it was based on what is now a completely anachronistic perception of the company form and shareholder relations to it alone is cause for serious concern.

Conclusion

Let us for a moment relieve our minds from the trammels imposed by a technical use of words and look to the substance and reality of the thing.

Lord Colonsay, *Oakes v Turquand*⁵⁷

The judgments in *Re Addlestone Linoleum Company* (1887)⁵⁸ had the effect of consolidating the abovementioned developments in the common law relating to shareholder claims on insolvency in the consideration of statute. Through the application of the rationales in *Houldsworth* and prior cases to relevant legislation apparent in this case the reasoning in *Houldsworth* has come to influence the interpretation of relevant legislative provisions to the present day. While Gleeson CJ stated that it was not fruitful in the context of a determination in *Sons of Gwalia* to consider the extent to which the perception of inconsistency of shareholders claiming back monies from a company in insolvency in older cases was affected by partnership or capital maintenance principles, it is an important issue to consider in deciding the future direction of legislation.⁵⁹

This paper has shown that the historical development of the law in this area was tainted from the beginning by principles taken from partnership law and applied to the developing company form. Indeed Gummow J stated in the same case that earlier decisions demonstrated ‘not so much an analysis and construction of the statutory provision as an assimilation of the statutory provision with the prior learning applicable to the law of partnership’. As such, ‘doubt must be entertained as to the appropriateness of perpetuating this construction with respect to modern statutes’,⁶⁰ and, it must be added, in view of the changes in the nature of modern corporations and share ownership in them.

In the time since these decisions were handed down the business world has been witness to the accelerated development of the company form. Investor interaction with the corporate form has changed significantly, with share ownership now being exponentially more diffuse than it was in 19th century England. In view of the awkward influence of relatively ancient principles on modern decisions dealing with share ownership and corporate existence which have resulted in unjust outcomes for aggrieved shareholders, it appears necessary that the status of shareholders on the insolvency of companies in cases involving fraudulent or misleading behaviour be set clearly, one way or the other.⁶¹

Justice Austin has noted that ‘the effect of the *Sons of Gwalia* case is to compound the technicality of what was already an extremely technical and unsatisfactory part of the law’.⁶² This is especially since *Houldsworth* may still be found applicable in certain cases, such as when a claim is made by a subscribing shareholder when statutory liquidation provisions do not apply.⁶³ The rule in *Houldsworth’s case* as it has come to be articulated in subsequent cases has been shown to be based on what is now an anachronistic apprehension

of the company form and shareholder relations to it. It is submitted therefore that the rule in *Houldsworth's case* should be abrogated by statute to prevent it impacting in any further way upon the interpretation and application of modern corporations legislation.

Postscript

In its recent report, *Claims by Shareholders Against Insolvent Companies: Implications of the Sons of Gwalia Decision* released 30 January 2009, the Corporations and Markets Advisory Committee (CAMAC) agreed with the approach taken by the High Court in *Sons of Gwalia*, and recommended the abrogation of the rule in *Houldsworth's Case*.

Along with the need for certainty for market participants, the consideration of the 'significant shift in Australian corporations legislation'⁶⁴ and especially the continuous disclosure requirements formed the central planks of the CAMACs position, noting also the practical benefits of this position:

[A]nother aim of the continuous disclosure, and other corporate disclosure, requirements is to promote a properly informed market, thereby enhancing the integrity and reputation of that market and encouraging investment. All things being equal, prospective shareholders will be more likely to invest in the share market if they feel confident that they will have a meaningful remedy, should the companies in which they invest fail to make adequate disclosure. Promoting investor confidence in the equity market may generate greater liquidity in that market and offset, in whole or part, increased costs for companies in the smaller debt market.⁶⁵

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Endnotes

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- * This conference paper (full version) has been double-blind assessed by two referees.
1. West Australian, quoting report by Sons of Gwalia Administrators, 'Brothers of Gwalia face growling watchdog', 22 August 2005 available at: <<http://www.theage.com.au/news/business/brothers-of-gwalia-face-growling-watchdog/2005/08/21/1124562751752.html>>.
 2. Alan Kohler, 'Why did Gwalia fail? Ask the Lalor brothers' 20 August 2005, *The Age* available at: <<http://www.theage.com.au/news/alan-kohler/why-did-gwalia-fail-ask-the-lalor-brothers/2005/08/19/1124435144575.html?oneclick=true>>.
 3. *Sons of Gwalia Ltd (admin apptd) v Margaretic* [2007] HCA 1 (hereafter *Sons of Gwalia*).
 4. Trounson A, 'Gwalia ruling riles lenders', *The Australian*, 1 February 2007, p. 21; Editorial, 'Costello must restore balance', *Australian Financial Review*, 1 February 2007, p. 54; Bartholomeusz S, 'High Court decision opens can of worms for handling large-scale insolvencies', *The Age*, 1 February 2007, p. 8. See also CAMAC collated submissions available at <[http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2009/\\$file/Collated_submissions_Jan09.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2009/$file/Collated_submissions_Jan09.pdf)>. Aggrieved shareholders are defined by the Corporations and Markets Advisory Committee as persons who claim that loss to the value of their shareholding has been caused by some misconduct of the company for which they have a legal remedy against the company and does not cover shareholders who are simply disappointed with the outcome of their equity investment. See *Claims by Shareholders Against Insolvent Companies: Implications of the Sons of Gwalia Decision*, released 30 January 2009. Available at: <[http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2009/\\$file/Sons_of_Gwalia_Report.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2009/$file/Sons_of_Gwalia_Report.pdf)>.
 5. *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317 (hereafter *Houldsworth*).
 6. Ford HAJ, Austin RP, Ramsay IM, *Ford's Principles of Corporations Law*, Online Version, LexisNexis, Chatswood NSW. Chapter 24 at 24.507 and 24.510. *Houldsworth* may still be found applicable in certain

- cases, such as when a claim is made by a subscribing shareholder when statutory liquidation provisions do not apply.
7. *Oakes v Turquand* (1867) LR 2 HL 325.
 8. *Tennent v City of Glasgow Bank* (1879) 4 App Cas 615.
 9. *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317.
 10. Sifris M, Trichardt A, 'The Spectre of Houldsworth in the Antipodes' (2006) 27(5) *Company Lawyer* 155.
 11. *Oakes v Turquand* (1867) LR 2 HL 325 (hereafter *Oakes*).
 12. *Tennent v City of Glasgow Bank* (1879) 4 App Cas 615 (hereafter *Tennent*).
 13. 'If he [Oakes] fails to establish his right to be relieved from liability, Peek cannot possibly succeed'.
Oakes v Turquand (1867) LR 2 HL 325 at 341.
 14. *Oakes v Turquand* (1867) LR 2 HL 325 at 343.
 15. *Ibid.* at 346, the Lord Chancellor quoting *Clarke v Dickson* (1858) EB&E 148.
 16. *Henderson v The Royal British Bank* (1857) 7 E&B 356 (hereafter *Henderson's case*).
 17. *Oakes v Turquand* (1867) LR 2 HL 325 at 348 (emphasis added).
 18. *Ibid.* at 348.
 19. *Ibid.* at 367 (emphasis added).
 20. *Ibid.* at 373.
 21. *Ibid.* at 373-4.
 22. *Ibid.* at 374.
 23. *Salomon v Salomon & Co.* (1896), [1897] AC 22 HL (hereafter *Salomon*).
 24. *Oakes v Turquand* (1867) LR 2 HL 325 at 375.
 25. *Companies Act 1862* (UK), s 38(7).
 26. *Tennent v City of Glasgow Bank* (1879) 4 App Cas 615 at 620-1.
 27. *Ibid.* at 621.
 28. *Ibid.* at 622 (emphasis added).
 29. In appreciating the mindset through which the House of Lords approached this issue, it is important to understand the broader legal climate in which these decisions were made. Until 1825, the *Bubble Act 1720* UK required unincorporated joint stock companies to operate under the law of partnerships. While the Act was ultimately a failure, according to Mahoney, '[t]he real impact of the Bubble Act was to cut off any possibility of further development of a common law of joint-stock companies. By the time of the Bubble Act's repeal in 1825, judges, having had nothing to do with unincorporated joint-stock companies for a century, were determined to fit them into an existing legal category (e.g. partnership) rather than see them as a different form of contract altogether. The notion of separate legal personality without incorporation had ceased to reside in the judicial mind'. See P. Mahoney, 'Contract or Concession? An Essay on the History of Corporate Law' (2000) 34 *Georgia Law Review* 873 at 888. The result of course was the treatment of the company form in the same way the remains of a partnership would be administered; as a source for the satisfaction of the contingent claims of creditors.
 30. *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317 at 322.
 31. *Addie v The Western Bank of Scotland* (1867) LR 1 HL 145 (hereafter *Addie's Case*).
 32. *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317 at 323 (emphasis added).
 33. *Ibid.* at 324.
 34. Note that s 22 of the *Companies Act 1862* UK declared that 'The Shares or other Interest of any Member in a Company under this Act shall be Personal Estate'.
 35. *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317 at 325 (emphasis added).
 36. *Ibid.* at 325 (emphasis added).
 37. 'Any such application of the assets and contributions would not be in accordance but at variance with the contract into which the new partner has entered'. *Ibid.* at 325.
 38. *Ibid.* at 325.
 39. *Ibid.* at 326.
 40. *Ibid.* at 329 (emphasis added).
 41. *Ibid.* at 329.
 42. *Ibid.* at 329.
 43. *Ibid.* at 329.
 44. *Ibid.* at 330 (emphasis added).
 45. *Ibid.* at 332.
 46. *Ibid.* at 333.
 47. 'What end would there ever be to the interlacing claims on the part of misled shareholders inter se as to dividends received whereby the fund which might have been applied towards recouping and making good the debts of the company, including the damages claimed by the Appellant, was diminished?' *Ibid.* at 333.
 48. *Ibid.* at 334.

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49. *Ibid.* at 335.
 50. *Ibid.* at 337 (emphasis added).
 51. *Ibid.* at 337-8.
 52. *Ibid.* at 323.
 53. *Ibid.* at 325.
 54. *Ibid.* at 324.
 55. *Ibid.* at 332.
 56. *State of Victoria v Hodgson* (1992) 2 VR 613 per Tadgell J at 625.
 57. Lord Colonsay in *Oakes v Turquand* (1867) LR 2 HL 325 at 376.
 58. *Re Addlestone Linoleum Company* (1887) LR 37 Ch.D. 191 (hereafter *Addlestone*).
 59. *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1 at 21.
 60. *Ibid.* at 93.
 61. Indeed, unlike the more refined state of the law that exists in other jurisdictions such as the US where all shareholder claims are subordinated, and the UK where by virtue of s 111A shareholder claims are allowed to rank with creditor claims, Gummow J in *Sons of Gwalia* remarked that the legislation in s 563A 'has not been marked by any close legislative consideration of the ends sought to be achieved by a provision in the terms of s 563A'. *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1 at 42.
 62. Justice Austin, 'Implications of the Sons of Gwalia Decision: A commentary on the paper by Konrad de Kerloy', Law Council of Australia (Business Law Section) Corporations Workshop, 20-22 July 2007. See <http://www.lawlink.nsw.gov.au/lawlink/supreme_court/ll_sc.nsf/pages/SCO_austin200707>.
 63. Ford HAJ, Austin RP, Ramsay IM, *Ford's Principles of Corporations Law*, Online Version, LexisNexis, Chatswood NSW. Chapter 24 at 24.507 and 24.510.
 64. The Corporations and Markets Advisory Committee (CAMAC) report, *Claims by Shareholders Against Insolvent Companies: Implications of the Sons of Gwalia Decision*, released 30 January 2009, at 63. Available at <[http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2009/\\$file/Sons_of_Gwalia_Report.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2009/$file/Sons_of_Gwalia_Report.pdf)>, last viewed 9 March 2009.
 65. *Ibid.* at 49.