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### **Redeemable preference shareholders in an administration or winding up**

#### **Introduction**

A recent decision of the Supreme Court of New South Wales has clarified whether redeemable preference shareholders of a company under administration hold their rights against the company as creditors, or as shareholders.

In the decision in question, *Heesh v Baker* [2008] NSWSC 711 (*Heesh v Baker*), justice Barrett found that redeemable preference shareholders who had acquired shares pursuant to a prospectus were **not creditors** of the company in question for the purposes of Part 5.3A of the *Corporations Act 2001* (Cth) (the Act). Their rights against the company lay as members only.

This finding was limited, however, to their rights under the prospectus and the constitution only. It was also despite these shareholders being (aside from a small number of minor creditors), the only major potential creditors of the company, with the directors' belief of insolvency based on the shareholders being creditors in respect of their rights of redemption, and to dividends.

#### **Factual background**

The company in question, York Capital Limited (**York**) was registered as a company in July 2006. Its business was the provision of loans and other financial facilities. Shortly after its registration, York lodged a prospectus inviting subscription for redeemable preference shares referred to in both the constitution and the prospectus as the 'CPRPS shares'.

*According to the prospectus, CPRPS shareholders would have rights to:*

- (a) *Cumulative dividends at particular rates and dates depending upon the shares acquired; and*
- (b) *Redemption on the 'Redemption Date', in each case depending on the class of share.*

Redemption was expressed to be available to an investor (shareholder) by written request to York at least two business days prior to the Redemption date.

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York's constitution also contained provisions governing rights of the CPRPS shareholders, and other shareholders of the company. The constitution referred to a right to redeem shares on or before the Redemption date, rights to dividends, the right to share in York's surplus capital on a winding up (in preference to other shareholders) and certain voting rights.

The prospectus also recognised and noted provisions of the Act governing the issue of redeemable preference shares, limiting the circumstances in which the shares can be redeemed, and regulating the declaration and payment of dividends. These provisions are discussed further below.

Whilst dividends were initially declared and paid on the dates due, from late 2007 York's directors did not declare or pay any further dividends. York also failed to redeem the shares on the dates specified in the prospectus.

On 5 June 2008, York's directors appointed administrators. The administrators received proofs of debt from many of the CPRPS shareholders, each claiming monies allegedly due based on York's failure to redeem their shares on the due date, and/or its failure to pay dividends. York's assets were sufficient to pay the small number of other claims made, but were insufficient to meet the claims made by the CPRPS shareholders in full.

The administrators sought directions and declarations as to the status of the rights of the shareholders. Their status was particularly relevant as, given York's financial position, it would only be insolvent (justifying the administration continuing) if the CPRPS shareholders were also creditors of York.

## **Corporations Act provisions**

Redeemable preference shares are defined in s 9 of the Act as '*a preference share in a body corporate that is, or at the body corporate's option is to be, liable to be redeemed*'. Under s 254A(3) of the Act, a redeemable preference share can be redeemable either at a fixed time, on the happening of a particular event, at the company's option or at the shareholder's option.

On redemption, the shares are cancelled (s 254j). However, s 254K of the Act restricts redemption, as follows:

*A company may only redeem redeemable preference shares:*

- (a) *If the shares are fully paid up; and*
- (b) *Out of profits or the proceeds of a new issue of shares made for the purposes of redemption.*

*Note: for a director's duty to prevent insolvent trading on redeemable preference shares, see section 588G.*

The Act also imposes restrictions on directors' powers to declare dividends. Under s 254T, a dividend may only be paid out of profits. Section 254v further states that '*a company does not incur a debt merely by fixing the amount or time for payment of a dividend. The debt arises only when the time fixed for payment arrives and the decision to pay the dividend may be revoked at any time before then*'.

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Section 588G, relating to directors' liability for insolvent trading, is also of some relevance. Section 588G(1A) indicates that, for the purposes of that section, a company is taken to have incurred a debt at a time set out in the relevant column. In relation to redeemable preference shares that are redeemable otherwise than at the company's option, the table in s 588G(1A) deems a debt to be incurred (for the purposes of s 588G) *'when the shares are issued'*.

## Finding of the Court

Justice Barrett considered the rights of the CPRPS Shareholders to dividends and to the redemption of their shares on the dates indicated in the prospectus. His consideration extended only to rights under the prospectus and constitution.

His Honour noted that the test of whether a person was a creditor was that stated in *Brash Holdings v Katile* [1996] 1 vR 24. Unless a particular provision indicates otherwise, creditors for the purpose of Part 5.3A are those creditors who would have admissible claims under s 553 of the Act if the company went into liquidation.

In relation to dividends, his Honour found that:

- The right to a cumulative dividend required undeclared entitlements to be carried forward until declared;
- No debt would arise, however, until a final dividend was declared;
- A dividend could only be declared out of profits, the term 'profit' meaning as disclosed by financial statements formally drawn up and adopted;
- It may be appropriate for profits to be carried to a reserve, or used for other purposes, rather than being treated as available for dividends;
- Until a dividend was declared, however, no breach of contract or indebtedness from the company to the member arose;
- In this case all dividends declared had been paid. York was not therefore indebted to any member for unpaid dividends, and they were not creditors under Part 5.3A in respect of unpaid dividends.

In relation to redemption rights, his Honour found that:

- As recognised in the prospectus, under s 254K of the Act, York could only redeem the shares *'out of profits or the proceeds of the new issue of shares made for the purposes of the redemption'*. If neither *'profits'* nor *'proceeds'* were available, it was not lawful for the company to redeem the shares;
- This was expressly recognised in the prospectus;
- Whilst the prospectus referred to an alternative of a selective buy back of the shares, this was, from York's perspective, optional;
- As with dividends, the *'profits'* required for the company to be able to redeem must be disclosed in formally drawn and adopted financial statements;

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- In the present case, the obligation to redeem, as comprised in the constitution and prospectus as between York and the CPRPS shareholders, was not absolute. It was expressed to be subject to the requirements of the Act, and profits being available. Therefore, consistent with an earlier decision of the Full Federal Court, *Federal Commissioner of Taxation v Coppleson* (1981) 39 ALR 30, York was not in breach of contract by its failure to redeem on the relevant dates;
- in the circumstances, the CPRPS shareholders were not creditors of York within the meaning of Part 5.3A of the Act;
- there may be some contracts between shareholder and company which impose an ‘*absolute obligation to redeem*’ (or pay specified dividends), in which case even if that failure was due to an unavailability of a fund for the payment to be made, a breach of contract would occur. The question was ultimately one of construction.

His Honour also referred to the possibility of a just and equitable winding up application by a shareholder where a company was unable to redeem because of profits being unavailable (as was the position in this case). He also referred to s 588G(1A) of the Act, and noted that section was a deeming provision purely for the purposes of s 588G. It did not alter the position of the CPRPS shareholders as against the company.

## **Practical significance**

The decision provides useful guidance to practitioners assessing proofs of debt lodged by redeemable preference shareholders. As in *Heesh v Baker*, many of those shareholders may believe they are creditors of the company, and lodge proofs of debt claiming the right to return of monies and unpaid dividends.

Whether those shareholders are creditors for the purposes of Part 5.3A, (and likely also in a winding up) will depend on the contract between the shareholder and company. In relation to dividends:

- any declared but unpaid dividends will entitle the shareholder to lodge a proof of debt;
- in relation to dividends not declared, whether the shareholder has a claim against the company will depend on the shareholding contract. In the case of York, the shareholders did not have admissible claims as creditors (for unpaid dividends) because York had not earned sufficient profits, and the shareholding contract was made subject to obligations under the Act preventing a company from paying dividends otherwise than out of profits;
- most shareholding contracts (the constitution and other document governing the share issue) recognise or incorporate obligations under the Act, and make the declaration of dividends at the directors’ discretion. In such cases shareholders will be unable to lodge claims for unpaid dividends in the administration.

In the case of unmet redemptions, given a company’s obligation under the Act to redeem only out of profits, most shareholding contracts will also expressly recognise and incorporate the restriction on rights of redemption imposed by the Act into the shareholding contract. This means that if a company fails to redeem based on unavailable profits, the shareholder will generally not be entitled to lodge a claim in an administration or liquidation.

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*Heesh v Baker* leaves open the question, however, of what precise remedies will be available to redeemable preference shareholders in cases where their contract with the company gives an absolute right of redemption or dividends, and whether those claims enable them to lodge proofs of debt in a winding up or administration. Justice Barrett noted that an absolute obligation would give rise to a breach of contract even if funds were unavailable for that payment to be lawfully made. Presumably this is also despite the company being in breach of the Act in honouring the contract.

A further alternative is where a company has failed to redeem or declare dividends even when profits were available. Justice Barrett indicated such shareholders would also have claims for breach of contract, although the remedy available may be only to seek specific performance (rather than damages). Grounds may also exist for a just and equitable winding up.

Redeemable preference shareholders may also be creditors of the company on other bases, for example in claims under statute for misleading and deceptive conduct on a *Sons of Gwalia* type claim (refer *Sons of Gwalia v Margaretic* [2007] HCA 1). No claims of this nature were lodged in the *York* administration, however, and the declaration made did not extend to any such claims.

Practitioners must therefore consider carefully the claim being made by the shareholder, and whether, in the circumstances of the shareholding contract, that right gives rise to an admissible claim under Part 5.3A, or in a winding up.

Practitioners should also note that claims by shareholders for redemption or dividend rights will be, even if admitted in an administration or liquidation, postponed to other debts of the company under s 563A of the Act. This section postpones the payment of debts claimed by members in their capacity as members, whether by way of dividends, profits or otherwise, until payments to other creditors are satisfied. The section expressly applies to dividend rights and would likely apply to any rights arising from a company's failure to redeem shares (if admissible), as this is a claim arising from the shareholding contract.

This is to be compared with claims under statute for misleading and deceptive conduct, which the High Court has found are not claims postponed under s 563A (refer *Sons of Gwalia* above).

Given the postponement of claims by members (in that capacity) until other creditors are paid, whether such shareholders are creditors will generally only bear practical relevance in relation to admitting such persons for voting purposes. As such claims (if admitted) will be postponed anyway, the issue will be relevant for the purpose of dividend distributions only in administrations where the company has sufficient funds to pay all other creditors in full. Such administrations are rare.

A final point to note is Justice Barrett's comments on s 588G(1A) of the Act. As indicated by his Honour, that section is a deeming provision, and applies in the context of a director's insolvent trading claim only. Practitioners should be aware, however, of the time at which companies are deemed to have incurred a debt under that section in the context of redeemable preference shares. For the purposes of s 588G, this will be, in the case of redeemable shares which are redeemable at the shareholder's option (rather than the company's option) when the shares are issued. This will therefore be the relevant date to consider in any insolvent trading investigation.



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