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Credit Markets and the Sons of Gwalia Judgement

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This paper examines the, potentially serious, consequences of a recent Federal Court of Australia decision for the cost of unsecured borrowing by Australian companies. The case in question is 'Sons of Gwalia Limited (Administrators Appointed) v Margaretic [2005] FCA 1305'. The decision of Justice Emmett (released on 15 September 2005), if not reversed on appeal, changes fundamentally the nature of shareholder's claims on the assets of an Australian company in the event of failure. In February 2006, the full bench of the Federal Court upheld the earlier decision (Buffini, 2006), and an appeal to the High Court by the liquidators and some creditors was heard on August 7-8 2006, with the judgment pending at the time of writing.

The effect of the Sons of Gwalia case is that shareholders purchasing shares shortly before a company is placed into administration may be able to claim compensation from the company's remaining assets and, in doing so, rank equally with unsecured creditors. These additional claims dilute the claims of unsecured creditors and would reduce the payout they receive relative to the amount owed.

Potential lenders to any Australian company are then, as a result of the Sons of Gwalia case, confronted with higher risk on unsecured debts (a lower recovery rate in the case of company failure) than before. Consequently we would expect interest rates charged on unsecured debt to increase to compensate for the increased risk. That is a question of interest to corporate debt markets, since corporate bonds are typically unsecured (and sometimes subordinated), and to other unsecured creditors such as trade creditors where such effects would show up as increases in the implicit interest rate involved in trade credit terms and conditions.

In this paper, we adapt modern techniques of credit risk modelling to estimate the magnitude of such an effect, and how sensitive it is to various economic characteristics of the companies involved. We find that the increased return which would be required by unsecured lenders is significant for many companies. We start with a section outlining the major features of the Sons of Gwalia case and explain why it leads to the outcome of some shareholders ranking equally with unsecured creditors in the event of failure (but not otherwise). We then explain how option pricing theory can be used to derive required credit spreads (the rates of return in excess of a risk free interest rate required by lenders) and adapted to this particular case. To estimate likely changes in credit spreads using such

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models it is necessary to have some idea of the dilution effect on unsecured creditor payoffs arising from the elevation of shareholder claims. This is followed by a section which provides new data on the value of share turnover in periods prior to company failure and its size relative to unsecured debt outstanding for a sample of recently failed companies. This gives the inputs required to estimate the impact of Sons of Gwalia on credit spreads, and the estimates are presented in the next section. We conclude with some discussion of policy issues and other considerations for credit markets raised by the Sons of Gwalia judgment and provide some suggestions for further research.

Sons of Gwalia Limited (Administrators Appointed) v Margaretic

Justice Emmett's decision involved a finding in favour of a shareholder in Sons of Gwalia Ltd (an Australian company with stock market capitalisation of approximately $600 million 6 months prior to insolvency) who claimed to be entitled to the status of a creditor of the company. The shareholder had purchased shares shortly before the company's failure during a period in which it is argued that the market was not fully informed about the company's financial position.

The class action case (funded by litigation funding group IMF Australia) relies on section 52 of the Trade Practices Act and gives rise to shareholders who are misled by a company having a right to compensation under consumer protection laws. Justice Emmett in handing down the decision said that the claim arose 'as a result of the consumer protection provisions … which prohibit misleading and deceptive conduct'. The claim is in respect of 600 shareholders who will compete for a $400 million pool of assets with creditors owed some $900 million (Buffini, 2005). The decision drew on precedent established in English Law, and relates specifically to the interpretation of Section 563A of the Australian Corporations Act.

The rationale for the decision is outlined in Malleson Stephen Jacques (2005), which states that Section 563A implies that:

> the claim of a shareholder against a company subject to winding up proceedings is postponed or subordinated to the claims of other creditors of the insolvent company, where the shareholder's claim is in that person's 'capacity as a member of the company'. However, subordination would not be required if the shareholder's claim against the company is not in that shareholder's 'capacity as a member'.

Mr Margetic's claim was based on the argument that Sons of Gwalia had engaged in misleading conduct (under the Trade Practices Act, the Corporations Act, and the Australian Securities and Investments Commission Act) by not meeting its continuous disclosure requirements. Because those Acts provide for payment of damages, he would, it was argued, be eligible for compensation for loss suffered from purchase of shares. This would not be in his capacity as a

member of the company, and he should thus be eligible to rank equally with other (unsecured) creditors under Section 563A of the Australian Corporations Act.

The Sons of Gwalia judgment thus raises the spectre of fundamental changes in the status of claims of various stakeholders of an insolvent company. Specifically, some shareholders may be treated as having a claim equivalent to that of unsecured creditors. Those shareholders would be the ones who had purchased shares over some period prior to the company entering administration, if it could be shown that the company had not disclosed all relevant information to the market. The judgment is specific in limiting application to that category of shareholders, in situations of administration. Whether logic, rather than law, suggests similar implications for longer term shareholders, for those who subscribed for shares as part of a capital raising, or even for shareholders of a solvent company where non-disclosure was proved, are matters we postpone for later discussion.

It is tempting to focus upon the implications of this judgment for the consequences arising when failure has occurred. The administration process may become more costly and drawn out, as the validity of shareholder claims must be determined in the courts. The recovery rates of unsecured creditors would be diluted by the expansion of their ranks to include some subset of shareholders.

Indeed, the uncertainty surrounding the eventual outcome of appeals against the decision has already impacted upon the administration process for other Australian companies which have recently entered financial distress. In the case of ION Limited, which was suspended from trading in December 2004, with unsecured debts in the order of $369 million (as reported in the Balance Sheet for June 2004), the administrators have delayed distributions to creditors because of the uncertainty over whether claims by shareholders will rank equivalently. At November 2005, the administrators advised that 'some 2,500 proofs [from shareholders] have been received totalling approximately $113m'. (McGrathNicol+Partners, 2005).

But potentially more interesting, and more complex, are the general effects which would be observed in credit markets. Lenders to any company, in setting credit terms, take into account the possibility that the company may default and that they will not fully recover the amount owed. The lower recovery rates implied under the Sons of Gwalia judgment would mean that credit spreads would increase. In the following section we explain how modern techniques of credit risk modelling can be adapted to estimate the size of this effect.

Option Pricing Framework

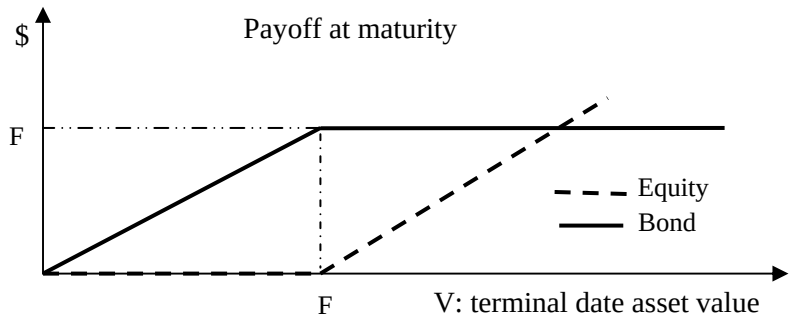
Under the Sons of Gwalia decision, the court gives a group of shareholders the right to act as unsecured creditors of a company which has become insolvent. This does not affect the probability of insolvency occurring, but reduces the recovery rate of other unsecured creditors should insolvency occur. Consequently, the rate of return demanded by unsecured creditors should increase to compensate for this increase in risk. In practice, many unsecured creditors are trade creditors,

and thus the credit spread effects we examine show up as changes in trade credit terms and conditions. In this section we develop a framework to assess how the Sons of Gwalia decision affects the value of an unsecured creditor's claim on the assets of a company, and thus the likely impact on the rate of return which would be demanded by an unsecured creditor.

Unsecured debt only

Assume first that the company has only unsecured debt on issue. Figure 1 provides a simple depiction of how the assets of the company are divided between shareholders and creditors at the debt maturity date (T). V_T is the value of the firm's assets at T and F is the promised repayment amount of the debt[1]. If the firm's assets exceed the amount owed to creditors (V_T >F), the firm is solvent, creditors are paid the promised amount, the value of shareholder equity is (V_T – F)>0 and the firm survives into the future. If the promises to creditors cannot be met (V_T<F), the firm is placed in administration with creditors receiving all of the available assets. Hence the (dashed) payoff line for equity holders is zero up to the point F on the diagram, and the payoff to bondholders is given by the solid line

Figure 1: Traditional Modelling of Debt and Equity Payoffs



As Merton (1974) noted, this payoff structure for holders of risky debt can be shown to be equivalent to holding a risk-free debt and having granted an option to the shareholders to put (that is, transfer the ownership of) the firm's assets to the bondholders, in the event of the firm defaulting, in settlement of the debt. Hence holding risky debt can be modelled as being equivalent to holding riskless debt plus being short (that is, having written or sold) a put option on the firm's assets. Shareholders 'own' the put option on the assets of the firm because they have

[1] The modelling assumes that the debt is of the zero-coupon variety, such that no payment is due until the maturity date. In practice, such debt is uncommon, as is the assumption that all unsecured debt outstanding matures at the same date. However, it is possible to approximate many of the characteristics of a portfolio of coupon bearing debts with different maturities by a single zero-coupon security.

limited liability and can 'walk away' from the obligation (of F) to creditors by forfeiting the firm's remaining assets (V_T) to them.

The benefit of adopting this perspective is that finance theory offers a method to derive the value of, and the required yield on, the risky debt at its issue date (or any time prior to its maturity) by drawing upon option pricing theory. Prior to the maturity date, the price of the put option can be calculated using the option pricing model developed by Black and Scholes (1973). Merton (1974) demonstrated how the credit spread can then be simply derived.

Merton's approach involved noting that a risk free discount bond promising F at time T with a risk free yield of r per cent, would have a higher current market value than the risky bond promising the same amount. The difference is the value of the put option over the firm's assets (V) for a strike price of F. Since the value of the risk free bond and the put option can both be calculated using finance theory, the implied market value of the risky bond (B) can then be derived. The required yield on the risky bond (y) is derived as the discount rate which equates the present value of the promised payoff F at time T to the derived market value B. The credit spread is then given by $c = y - r$. For any specified maturity, the credit spread turns out to be a function of only two variables: the variance (or volatility) of the firm's assets and the leverage of the firm. The higher is leverage — measured here as the ratio of the promised debt payment (discounted at the risk free rate) to the current value of the firm — the higher is the credit spread. The higher is asset volatility, the higher the credit spread.[2]

Assume now that a group of the shareholders is deemed to rank equally with unsecured creditors in the event of insolvency. Unsecured creditors are owed F, and let the shareholder group's claim on the company's assets be equal to X. If the firm value is greater than F, the unsecured creditors receive the full value of their claim. When the firm value V_T is below F, the firm is in default (insolvency occurs) and the unsecured creditors' claim is now diluted to F/(F+X) of the available assets. Note that even though the claims when insolvency occurs are (F+X), insolvency is not triggered until firm assets fall below the debt holder claims of F. The payoff for unsecured creditors when shareholders have a claim to X/(F+X) of the remaining assets in insolvency is illustrated in Figure 2.

The graphical depiction of the claims of the various stakeholders (as in Figures 1 and 2) provides insight into how the payoff can be constructed from a combination of fundamental instruments. In Figure 1 the fundamental instruments were a riskless bond and a put option on the firm's assets. In Figure 2 the payoff can be modelled as equivalent to a long (bought) position in a riskless bond of face value [F/(F+X)]F, plus a short (sold) position in [F/(F+X)] put options with strike price F, plus a long position in a digital option that pays [X/(F+X)]F when $V_T > F$ and zero otherwise. Table 1 illustrates how the payoffs from this combination of financial instruments leads to a payoff of F when the firm is solvent ($V_T>F$) and a payoff of $[F/(F+X)]V_T$ when the firm is insolvent ($V_T<F$). The first two

[2] Explicit formulae for the pricing and credit spread equations are available on request from the authors.

components are equivalent to a proportion [F/(F+X)] of a risky bond with face value F. Each of these components can be valued using option pricing theory and the overall value of the security whose payoff is given in Figure 2 is obtained by summing the value of the components. The credit spread for unsecured debt in this case (c*) can be calculated similarly to before, and the impact of the change implied by the Sons of Gwalia judgment measured by the difference in the credit spreads, or (c*-c).

Figure 2: Debt Payoff When Dilution by Equal Status of Some Shareholder Claims Occurs

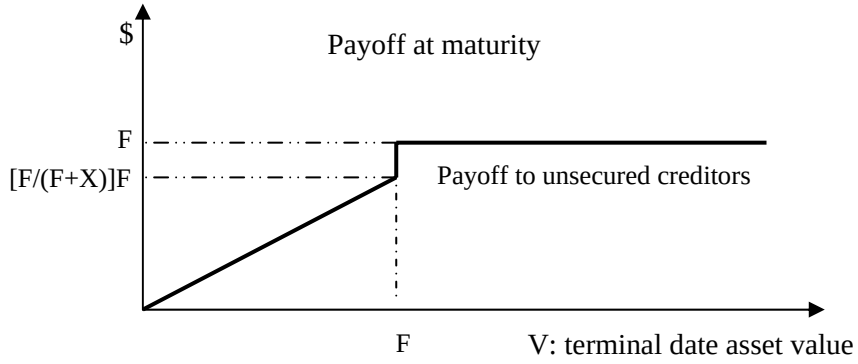


Table 1: Payoffs of Replicating Portfolio for Risky Debt When Dilution Occurs

	Payoffs	
	$V_T < F$ Insolvency	$V_T > F$ Solvency
Long riskless bond promising $\frac{F}{X+F}F$	$\frac{F}{X+F}F$	$\frac{F}{X+F}F$
Short $\frac{F}{X+F}$ puts at strike of F	$-\frac{F}{X+F}(F-V_T)$	0
Long digital option paying $\frac{F}{X+F}F$	0	$\frac{F}{X+F}F$
	$\frac{F}{X+F}V_T$	F

Secured and unsecured debt

Assume now that the firm has both secured debt with face value F_S and unsecured debt with face value F_U. When the firm is solvent at maturity of the debt ($V_T>F_S+F_U$) the unsecured (secured) creditors are paid the promised amount F_U (F_S). When the promises to all creditors cannot be met ($V_T< F_S+F_U$) but $V_T>F_S$ then secured creditors will be paid in full and unsecured creditors receive any excess of firm value over F_S. In the event that $V_T<F_S$, unsecured creditors receive nothing. This payoff to unsecured creditors in the absence of dilution by shareholder claims is given in Figure 3. The payoff can be shown to be equivalent to the payoff on a long (bought) call option with strike price F_S and a short (sold) call option with strike price F_S+F_U. These options can be priced using the Black and Scholes (1973) formula and the credit spread calculated using the method outlined earlier.

Figure 3: Traditional Payoff to Unsecured Creditors when Secured Debt Exists

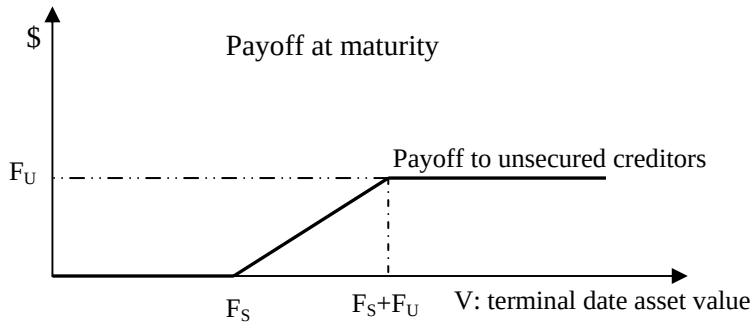
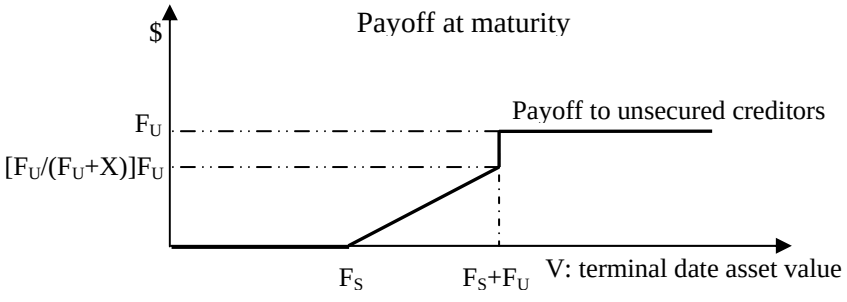


Figure 4: Unsecured Debt Payoff when Secured Debt Exists and Dilution by Shareholder Claims Occurs



When a group of shareholders with claim X is ranked equally with the unsecured creditors in the event of insolvency, the payoff to the unsecured creditors is illustrated in Figure 4. The approach to constructing Figure 4 from Figure 3 is identical to that used to construct Figure 2 from Figure 1. In this case when the promises to creditors cannot be met ($V_T < F_S+F_U$), but $V_T > F_S$, then secured creditors will be paid in full and unsecured creditors' claim is now diluted to $F_U/(F_U+X)$ of the available assets. It can be shown that this payoff is equivalent to $[F_U/(F_U+X)]$ times the payoff on unsecured debt when all shareholders rank after unsecured creditors (as illustrated in Figure 3) plus a digital option which pays $[X/(F_U+X)]F_U$ when $V > F_S+F_U$ and 0 otherwise.

Consequently, the bond price and credit spread can be calculated using option pricing theory and, as in the previous section, the change in credit spread resulting from the change in status of shareholder claims can be calculated.

Potential Size of Shareholder Claims

The Sons of Gwalia judgement was the result of a class action mounted by a specialist litigation funding company on behalf of a group of shareholders. How many shareholders would, in general, rank as unsecured claimants, and the value of their claims relative to that of unsecured creditors, is (in the absence of precedent) unknown. Since the judgement is based on shareholders purchasing shares under a situation of misinformation, it is likely that implementation of such a ruling would be limited to those investors who became new shareholders in some limited number of months prior to the insolvency occurring.

To gain some understanding of likely magnitudes involved, we have collected data on the share turnover of failed companies in the period prior to insolvency. For the calendar years 2003, 2004 and 2005 we have identified (using www.delisted.com.au) 52 listed companies which were delisted from the ASX as a result of insolvency.

The path to insolvency can be complex, sometimes involving prior announcements or market rumours of trading difficulties. Consequently, in some cases it is unlikely that purchasers of shares in some short period prior to delisting would be able to sustain a case for compensation as claimants on the company. For this reason, companies which did not appear to have traded, or had a history of very thin trading or were 'penny dreadful' stocks with a share price of a few cents were removed from the sample (the list of companies retained in the sample is available from the authors on request). This left 30 stocks for which data on trading volume and value for a period prior to delisting were available.

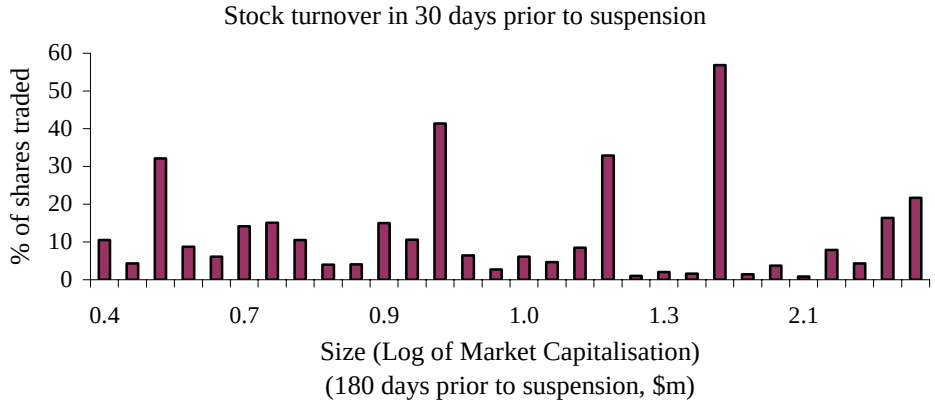
We use the date of suspension from trading associated with, or prior to, the announcement of an administrator as the basis for calculating share purchase volumes and values in the period prior to an insolvency. We have calculated both the value and volume of shares purchased for a range of periods prior to suspension, and report results for the 30 and 90 day periods. The volume of shares is expressed as a percentage of the stock on issue. Note that these figures are an

upper bound for the number of recent purchasers holding the stock at the suspension date, since some purchasers may have resold the stock before the suspension. The severity of this problem increases with the length of period considered and also with the turnover rate for the stock.

We have also collected data on the value of unsecured creditors (measured as total liabilities minus secured creditors) of companies in our sample as at the last available balance sheet date prior to suspension. In some cases this may be as much as 18 months prior to suspension (since subsequent annual reports may not have been filed). To our knowledge, the question of whether, on average, unsecured debts increase or decrease in the months prior to insolvency has not been fully resolved, and hence we take this figure as indicative of the size of unsecured debt outstanding at the time of suspension.

Figure 5 provides a perspective on the turnover of shares 30 days prior to suspension. It is clear that in many cases significant purchases of shares are made in a short period prior to failure, creating the possibility of substantial shareholder claims for compensation. There is no apparent relationship between size of the company (measured by market capitalisation 180 days prior to suspension) and the turnover of shares in the period leading up to insolvency. Turnover for Sons of Gwalia, at 21 per cent of stock outstanding, was the fifth highest in our sample.

Figure 5: Stock Turnover Prior to Share Market Suspension



The value of shares traded in a given period prior to insolvency relative to the amount owed to unsecured creditors varies markedly, reflecting both the volume of trading and the leverage of the company. Table 2 provides summary information on the dilution effect (corresponding to X/F in our earlier notation) by deciles based on a leverage measure. These dilution estimates are an upper bound since they do not allow for cases where recent purchasers have resold those shares prior to the company's failure. In Table 2, leverage is measured as unsecured debt (reported in the last annual report available prior to suspension) as a ratio to the company's market capitalisation 180 days prior to suspension (corresponding

approximately to F/(V-F) using our earlier notation). For companies with low leverage, the potential dilution effect is naturally very high. For companies with high leverage, the dilution effect is much less, even when there has been substantial stock turnover.

Table 2: Potential Equity Claimants Relative to Unsecured Creditors

Quintiles (based on leverage)	Leverage: Unsecured Debt/Equity Ratio (Average)	Dilution: Share Value Traded in 90 days prior to suspension as a ratio to Unsecured Debt
1 (lowest leverage)	9%	309%
2	31%	74%
3	66%	18%
4	111%	25%
5 (highest leverage)	513%	16%

Table 2 illustrates that there is clearly great diversity in the possible dilution effects on unsecured creditors arising from the Sons of Gwalia decision.

The data in Table 2 are *ex post*, but for the determination of credit spreads we require an estimate of the expected or average dilution effect as at some date prior to company failure. Consequently Table 3 provides some estimates of the average dilution effect, using different weighting methods. Based on our sample of failed companies, if all purchasers of shares in the thirty days prior to failure were eligible to rank equally with unsecured creditors as claimants, the dilution effect would be 37 per cent, using an unweighted average. Weighting the data by leverage, the dilution effect falls to six per cent.

Table 3: Ratio of Potential Equity Claimants/Unsecured Creditors

	Eligibility Period	
	30 days	90 days
Unweighted Average	37%	88%
Weighted Averages *Using*:		
Market Capitalisation	16%	41%
Leverage (Unsecured Debt/Market Capitalisation)	6%	24%

Likely Size of Sons of Gwalia Credit Spread Effect.

Our objective is to provide a 'ball-park' estimate of the likely changes in credit spreads on unsecured debt resulting from the Sons of Gwalia judgment. The information obtained from our study of recent company failures and described in the previous section provides us with some idea of reasonable input parameter values required to make such a calculation. The critical parameters, as outlined earlier are the dilution effect and volatility of the company's assets.

The dilution effect arises from a group of shareholders with claim X being ranked equally with unsecured creditors with claim F_U on the company's assets. Based on the data in Table 3, we choose dilution effects represented by a ratio of 0.4 for X/F_U as being realistic. In doing so, we note that the experience of ION referred to earlier involves claims lodged by shareholders of approximately $113m, which is equivalent to the value of shares purchased in the 60 days prior to delisting. In Table 4 we show results from calculating the increase in credit spread assuming that the company has both secured and unsecured debt on issue. We assume a volatility of asset value of 30 per cent because, as shown by Duan *et al* (2004), this has been shown to calibrate the Merton model estimates of credit spreads to actual data. We choose a maturity of 5 years since this is a common initial maturity for corporate unsecured bond issues.

Table 4: Increase in Credit Spread on Unsecured Debt: Secured and Unsecured Debt Outstanding.

Unsecured Debt/Assets	*increase in credit spread (basis points)*						
0.8							161.0
0.7						127.5	152.3
0.6					94.4	119.8	140.6
0.5				63.2	87.9	108.9	125.0
0.4			35.9	58.1	78.1	94.0	105.8
0.3		15.2	32.4	49.8	64.3	75.3	83.2
0.2	3.5	13.2	25.9	37.3	46.4	53.0	57.8
	0.2	0.3	0.4	0.5	0.6	0.7	0.8
	Total Debt/Assets						

Notes: Debt to assets ratios are measured using the face value of debt and the market value of assets.

Volatility = 30% p.a., Maturity = 5 years, risk free interest rate = 5%, Dilution effect (shareholder proportion): $X/F_U = 0.4$.

Along the horizontal axis of Table 4 is the total debt to assets ratio and along the vertical asset is the unsecured debt to asset ratio. Thus, when the total debt to asset ratio is 0.8 and the unsecured debt to asset ratio is also 0.8, the company has only unsecured debt outstanding. For example for a company with only unsecured debt outstanding and a ratio of unsecured debt to assets of 0.7, the increase in

credit spread is 127.5 basis points on an initial spread of 183 basis points. When the total debt to assets ratio is 0.7 and the unsecured debt to assets ratio is 0.4, then unsecured debt forms 4/7 of the total debt and the increase in spread is 94 basis points. As would be expected, holding the total debt to assets ratio constant, the increase in credit spread is increasing in the proportion of the debt that is unsecured. If the same results were reproduced for a lower value of X/F_U the patterns remain the same, but the corresponding increases in the credit spreads are lower. For example if $X/F_U = 0.2$ for a company with unsecured debt only, the increase in credit spread is 73.4 basis points when the unsecured debt to assets ratio is 0.7. This compares with a 127.5 basis point increase when $X/F_U = 0.4$.

It would be possible to make a range of estimates of the potential increases in credit spreads arising from implementation of the Sons of Gwalia decision for companies with different characteristics in addition to the differences in leverage examined in Table 4. Different volatility figures and time to maturity for unsecured debt could be assumed. Different dilution factors could also be applied.

However, the basic message of the results presented above is clear: the credit spread on unsecured debt for Australian companies could increase substantially. This would be particularly so for companies heavily reliant on unsecured debt, those with volatile share prices, and those with a relatively high share turnover.

Conclusion

Notwithstanding the appeal to the High Court, the Sons of Gwalia decision implies that a shareholder would have an admissible claim against a company if the shares were bought on-market where a breach of contract such as misrepresentation by the company can be proven. Trading while insolvent would clearly fall into that category (and leave directors open to legal charges) but so also would appear to be situations in which full disclosure to the market of company performance had not occurred. Despite continuous disclosure requirements imposed by the Australian Stock Exchange, it is to be expected that companies entering financial distress are reluctant to publicise every piece of adverse information which may further hasten their decline. Consequently, there is likely to be some serious questioning of what constitutes information which should be provided to the market by Boards of Directors and Management. This may serve to focus discussion on the distinction between ‘inside’ (informed) and ‘outside’ (uninformed) equity stakeholders and the implications for legal rights of the latter group beyond their status in insolvency as addressed by the Sons of Gwalia judgment.

There are some more general questions raised by the judgment. First, why do recent purchasers of shares have a claim because of inadequate disclosure, when longer term shareholders, who may have sold if such information was disclosed, do not?[3] One answer, although legal considerations may provide others, is that

[3] It should also be noted that the courts have previously rejected a claim to participate in the division of assets in liquidation by shareholders who subscribed to a capital raising of a company which subsequently failed. (Malleson, Stephen Jacques, 2005).

such shareholders were owners of the company when the events causing its loss in value occurred, and disclosure would have reduced the share price causing them to suffer a loss on the sale of shares anyway. A further consideration is whether purchasers of shares would be able to claim against a solvent company for loss due to non-disclosure. This would appear possible under provisions of the various Acts referred to earlier dealing with misleading information, but proving such a case is likely to be substantially more problematic than the situation dealt with in the Sons of Gwalia case, where company failure occurs.

In this paper our focus has been exclusively on the implications of the judgment for corporate debt markets and specifically upon its consequences for corporate credit spreads (the cost of debt finance). It is apparent, however, that equity market values may also be affected. To the extent that shareholders gain at the expense of creditors when liquidation occurs, the judgment could be viewed as good news for shareholders of all companies, with consequent beneficial effects upon share prices. However, any such effect would be offset if credit spreads rise as argued above. Moreover, the general uncertainty of treatment of stakeholder claims engendered by the decision (and likelihood of further challenges) may have adverse effects upon the share prices of Australian companies.

These comments indicate a potentially valuable line for future research. Provided that market participants believed that there was some probability of the Sons of Gwalia decision surviving subsequent legal challenges, the announcement of the decision (and result of subsequent challenge) should have led to some increase in credit spreads in corporate debt markets. Examining whether that did, in fact occur, and how equity markets responded, to assess the extent which value was transferred between stakeholders and the extent of any more general uncertainty effects, is worthy of further study.

We have argued that the resulting ambiguity with regard to the traditionally accepted investor hierarchy of claims in the event of corporate collapse has the potential to affect credit spreads in the market for corporate debt. Using an option pricing framework and assuming a proportion of shareholders are reclassified as unsecured creditors we have provided some estimates of the potential increase in credit spreads to demonstrate that this is a matter of economic significance. Banks as lenders, trade creditors, and institutional investors as buyers of corporate bonds are all potentially affected, and the ability of Australian companies to issue debt into international markets (in competition for funds with overseas companies where creditor rights are not subject to such dilution effects) are adversely affected.

Of course, the Sons of Gwalia decision may not survive the legal and political processes, making it a temporary hiccup in Australian corporate finance. A US funds management arm of the Dutch banking and insurance group ING, which bought bonds issued by Sons of Gwalia, claimed that Justice Arthur Emmett ‘erred in law’ in his original decision and should have ruled that a shareholder's claim be ‘postponed until all debts owed to (creditors) have been satisfied’ (Catalano, 2005). ING’s Australian solicitor has stated that the whole unsecured creditor

base of Sons of Gwalia is owed $862m and that ING had decided to appeal to the High Court (Sexton, 2006).

It is likely that if the High Court upholds the Federal Court decision then lenders will lobby to have the Corporations Act changed, so that shareholders are always ranked behind creditors. It seems likely that political and economic expediency would lead to such a change. However, the Sons of Gwalia decision has opened a significant can of worms by recognizing that legal precedent implies that 'outsiders' who buy shares on-market are, in some way, akin to under-informed consumers entitled to some degree of protection at the expense of other stakeholders in the company. Changing the Corporations Act as suggested above would remove one possible form of such protection, but do nothing to address the underlying problem.

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