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Australia: The Rise of Shareholder Class Actions in Australia

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Shareholder vigilance

The Australian financial sector has undergone a facelift over the last 20 years and 'shareholder vigilance' is a phrase now appropriate to characterise our investment environment. Close to 55 per cent of adult Australians now own shares, either directly or though investments in managed funds and private superannuation.[1] That's the largest proportion in the world.[2] The increasing privatisation of government businesses and statutory corporations, the introduction of compulsory superannuation and the de-mutualisation of major insurance players such as AMP and the NRMA have contributed to that position.

The result is a larger number of institutions and individuals concerned about the performance of their shareholdings, and seeking new or more vigilant processes to enforce their rights as corporate stakeholders. That concern translates into a heightened focus on the principles of corporate governance and securities fraud, and the means for recovering losses that arise when those principles are ignored by companies, their directors and advisers.

Enter the shareholder class action, a private enforcement mechanism designed to empower individual shareholders to aggregate their common claims and prosecute them as a group, thereby purportedly achieving the goals of increased access to justice and more efficient use of judicial resources.

Investors, advisers and major corporations (as well as their lawyers) will increasingly need to familiarise themselves with fundamental principles of class action litigation as Australia's financial environment moves into a new era of regulatory vigilance and attention to corporate governance issues.

Building blocks of a shareholder class action

What exactly are shareholder class actions? Arguably, the best description was crafted 17 years ago by the Australian Law Reform Commission (**ALCR**) which said in its now famous 1988 report on grouped proceedings:

> A group of small shareholders suffer considerable financial loss as a result of misleading advice received from stockbrokers and the directors of the company in which significant amounts of their savings were invested. The shareholders also claim that the company failed to comply with the Australian Stock Exchange listing rules by neglecting to inform the market of factors likely to materially affect the market price of shares. Apart from rights in negligence against the stockbrokers, the shareholders would have had rights against the directors arising from the Companies Codes and the Securities Industry Codes. A grouping procedure could facilitate the recovery of loss by those affected and would offer the advantage of helping to ensure that all concerned were informed of the claim and shared in the result without having to commence individual proceedings.[3]

The description remains accurate. As the ALRC predicted, the building blocks of a shareholder class action are optimistic forecasts of corporate performance in the form of representations of things to come. Investors (and their lawyers) cherish those kinds of representations because they form one of the key information sources upon which financial decisions are routinely based. But, like weather forecasts, financial performance predictions are often completely wrong. And when they are, shareholders have a variety of legal avenues available to them. These rights are well established. Examples include:

- statutory remedies for misleading and deceptive conduct under the *Trade Practices Act 1974* (**TPA**); section 12DA of the *Australian Securities and Investments Commission Act 2001* (**ASIC Act**) and section 728 of the *Corporations Act 2001*
- tortious rights in relation to negligent misstatements

- rights in relation to breaches of the continuous disclosure rules of the Corporations Act (section 674(2))
- injunctive relief and damages available for persons whose interests are affected by a contravention of the Corporations Act (section 1324)
- proceedings to enforce compliance with the Australian Stock Exchange listing rules (section 793C).

These kinds of remedies have been litigated extensively in Australia and the United Stated in recent years.

The American experience

Most Australian lawyers are aware of the juggernaut that is the shareholder class action 'industry' in the United States. The February 2005 shareholder class action trend analysis prepared by NERA Economic Consulting further emphasises the magnitude and dynamics of the phenomenon.[4]

Three of the eight largest shareholder class action settlements in history occurred in 2004 (involving WorldCom—$2,575 million; Raytheon—$460 million and Bristol/Myers Squibb—$300 million). The value of the average shareholder class action settlement rose in 2004 by almost 33 per cent to $27.1 million and it is now thought that over any five year period, the average American public corporation faces a 10 per cent probability of being named as a defendant to at least one shareholder class action suit.

It is interesting that NERA found that in cases where an accounting firm joined as a co-defendant, settlement values increased by close to 66 per cent and cases involving an institutional investor as lead plaintiff settled for approximately 33 per cent more than other shareholder class action settlements. The reasons for this latter trend are not known, but possible theories include the retention by institutional investor plaintiffs of more effective legal counsel as well as a greater contribution by institutional investors to litigation strategy and more effective supervision of legal counsel.

Perhaps the statistic most resonant with the general public is that in over 40 per cent of cases, plaintiffs' lawyers have recovered 33 per cent or more of the settlement amount.

Why is any of this important to Australians? The answer is that these trends indicate that shareholder class actions are being used in an aggressive fashion to regulate corporate malfeasance. As the NERA report notes, although the loss of reputation and financial cost of major litigation have always served as an incentive for good corporate governance, shareholders are now employing these suits as a type of private regulatory tool to achieve both financial compensation and specific corporate governance reforms.

The Australian experience

The last five years has seen a number of shareholder class actions commenced in Australia. A description of some of the more prominent actions demonstrates the magnitude and frequency of this type of litigation.

- **GIO**: In 1999, GIO, its directors and an independent adviser were sued by Mr King on behalf of 68,000 shareholders who did not accept a takeover offer by AMP as a result of misleading statements in the Part B document required by the Corporations Act. GIO shareholders settled their proceedings for $112 million, Australia's largest shareholder class action settlement to date and the first solid indication from the judiciary that shareholder class actions could be successfully prosecuted (albeit at the interlocutory stage).
- **Media World**: In January 2005, a shareholder class action was repeatedly filed against Adam Clarke and certain of his companies for misleading and deceptive representations associated with Media World Communications. That company allegedly predicted it would achieve 14 per cent penetration of Australian television households within five years of commencing a video-on-demand service. After collecting approximately $35 million from investors between 2000 and 2004, Media World announced that the technology did not function as well as other commercially available technology and a class action was soon commenced.
- **Concept Sports**: A shareholder class action was filed in 2004 against Melbourne events and merchandising company Concept Sports. The claim alleges that Concept Sports and its directors breached the Corporations Act by issuing a misleading prospectus. It is alleged that the prospectus did not contain all of the

information that investors and their professional advisers would require to make an informed investment decision.

- **Sons of Gwalia**: A multimillion dollar shareholder class action is proceeding against Sons of Gwalia centred on allegations that the company engaged in misleading and deceptive conduct by failing to fully disclose its gold hedging commitments. That litigation is reportedly being funded by IMF, who have recently been prevented by the Federal Court from using Gwalia's share register to contact shareholders in order to increase the size of the class.

Can we expect more shareholder class actions of this kind? Almost certainly. The reasons arise both as a result of structural changes in the regulatory and investment environments, as well as recent changes to the law that remove some of the obstacles to the prosecution of shareholder class actions.

Sidestepping the Prudential Principle

It has been a longstanding principle of Australian law that a shareholder cannot recover damages merely because the company in which he or she has invested has suffered damage.[5] The Prudential Principle, as it has become known, stands for the proposition that a shareholder cannot recover a sum equal to the diminution in the market value of an investment because such a loss is merely a reflection of a loss suffered by the company. This is a reinforcement of the ancient rule that in relation to wrongs done to a company, it is the company that is the proper plaintiff to commence proceedings, not its shareholders.[6]

It is becoming clear that the Prudential Principle will not foreclose Australian shareholder class actions seeking damages for loss of share value. The Federal Court has recently held that, where shareholders are seeking remedies not dependant on their status as a shareholder, such as statutory rights in relation to conduct which misleads or deceives or tortious rights in relation to negligent misstatements, then it is the shareholders who are the proper plaintiffs and not the corporation.[7] This clarifies the availability of shareholder class actions in respect of the full suite if corporate malfeasance claims referred to at the outset of this paper, including remedies under the TPA, the ASIC Act and the Corporations Act.

Easier to sue multiple respondents

Since at least the decision in *King v GIO* (2000) 100 FCR 209, Australian lawyers had reason to believe that it was a requirement for all class actions that the lead plaintiff (the applicant) and all group members have a claim against each and every respondent.

In a shareholder class action, allegations often relate to various misrepresentations over a significant period of time, for example, some class members may have relied on misleading statements by directors as to profitability, some may have relied on an auditor's unqualified opinion of the accuracy of financial statements, and some may have relied on the advice of a financial adviser. An argument frequently raised in opposition to multiple respondent cases was that the applicant and each group member could not possibly have relied on each separate misrepresentation by each respondent and that the claims of all shareholders lacked the requisite commonality to enable them to group together.

This requirement may no longer exist in Australian law. Recent decisions in the Federal Court suggest that all that may be required is that the applicant and all group members have a claim against one respondent.[8] Although the legal position is far from determined, if it is no longer a requirement that each member of the class have a claim against each respondent, a previous obstacle to the prosecution of shareholder class actions seeking relief in relation to separate misrepresentations by various respondents over a significant period of time, may now be dissolved.

Regulator encouragement of class actions

There is an ever popular view among regulators and academics that shareholder class actions should be encouraged in order to supplement the often slow-moving cogs of government enforcement with much speedier private actions.[9] Private enforcement is frequently more intimidating to corporations, particularly in the case of shareholder class actions which can aggregate the claims of thousands or even millions of shareholder and thereby significant increase a corporation's legal exposure in comparison with the relatively meagre statutory fines that attach to corporate misfeasance.

Whatever the position, regulators in Australia are recognising that higher volumes of shareholder class actions would relieve the burden on statutory bodies such as ASIC and would mitigate the inability of small investors (who are relatively poorly resourced and have no experience of the legal mechanism), to identify corporate malfeasance and to prosecute in relation to failures in corporate governance or in respect of misleading corporate information.

To this end, it is interesting to note that ASIC investigations have been associated with a number of recent shareholder, including those against GIO and Aristocrat.

Calls for the relaxation of traditional costs rules

A number of commentators have also suggested that Australian litigation costs rules should be reformed to facilitate more shareholder class actions.[10]

Contingency fees are not permitted in Australia, although there are some fee arrangements that come very close to the US-style of fee levied as a proportion of any successful recovery. Speculative fees (that is, no-win no-pay arrangements) are permitted in all jurisdictions and some jurisdictions also permit a statutory uplift or loading on top of normal fees where a case is successfully prosecuted.

Notwithstanding these arrangements, Australia abides by the English rule whereby a successful party may claim its costs against the loser. The rule is generally considered to be an impediment against the prosecution of shareholder class action proceedings because of the potential burden it places on the applicant. From time to time, plaintiffs have argued (largely unsuccessfully) that the English rule should be displaced on the basis that there is a public interest in the prosecution of many types of class actions.[11]

Now more than ever, there is growing academic support for the proposition that public interest concerns are especially significant in the shareholder class action context because of the sheer number of individuals potentially affected by breaches of corporate governance and the benefits that can arise through aggressive private enforcement of corporate misfeasance. It is only a matter of time before these arguments are considered by the legislature in an effort to deal more effectively with the question of whether shareholder class actions should be encouraged as a form of what the Americans call 'private attorney general'.

The fraud on the market theory

In the Unites States, the fraud on the market theory has opened the door to thousands of shareholder class actions.

Before the theory emerged, the need for each individual shareholder to prove reliance on a particular misrepresentation (in establishing the requisite causation to prosecute the claim) meant that it was commonly impossible for class members to establish a sufficient 'commonality' of claims. Respondents would inevitably assert that proof of reliance on a misrepresentation was an inherently individual issue and that the existence of individual issues meant that the class action did not demonstrate a substantial common question worthy of prosecution in the aggregate form.

The fraud on the market theory assumes that the price of shares in an open and developed market reflects all publicly available material information about those shares, including materially false or misleading statements issued by a company. The theory presumes that shareholders rely on the integrity of the market price in making their investment decisions. Individual reliance becomes unnecessary to establish and the effect of the presumption is to relieve plaintiffs of the unrealistic prospect of proving that they acted on any one or more particular representation (which would give rise to multiple individual issues of proof), thereby facilitate the prosecution of the shareholder class action to trial.

Although the theory has not yet gained favour with an Australian court, it is inevitable that plaintiffs' lawyers will give it close consideration should proof of individual reliance remain an obstacle to class action prosecution.

Emergence of mainstream litigation funding

Litigation funding has traditionally been constrained by rules against maintenance and champerty. Those ancient rules restrain 'trafficking in litigation' and the assignment of the right to litigate to a third party.[12]

The position in Australia is now changing. Recent case law supports the proposition that in some circumstances a cause of action may be assigned where the assignee has some recognised interest in the cause of action.[13] The

apparent philosophy emerging in Australia is that litigation of the claims of shareholders in an aggregate form is increasingly in the public interest and consistent with the notions of access to justice and efficient use of judicial resources. The Federal Court has commented that increasingly the judiciary is able to take a wide view of what might be acceptable in terms of litigation funding, particularly if appropriate checks and balances on the integrity of the litigation process are otherwise able to be implemented to prevent an abuse.[14]

These changes in the judiciary's attitude towards litigation funding of course coincide with the emergence of major litigation funders in Australia, most notably IMF (Australia) Limited, a publicly listed company providing funding of legal claims and other related services. IMF claims to be the largest litigation funder in Australia and the only such listed company in the world. The increased availability of funding will have an obvious effect on the frequency with which shareholder class actions are prosecuted.

Futility of interlocutory challenge

Interlocutory challenges to shareholder class actions in Australia have been notoriously difficult (particularly in comparison to the position in the United States). Although skirmishes about pleadings are inevitable, Australian courts have traditionally allowed plaintiffs significant latitude in amending their pleadings to ensure that a class action is disclosed that confirms with the threshold requirements. The results is protracted interlocutory warfare between plaintiffs and defendants requiring multiple court appearances, numerous interlocutory judgments and significant legal costs to the parties. In short, once a shareholder class action is commenced, it is difficult to dispose of it quickly or cheaply.

Further developments

A very interesting debate is emerging as to the entitlement of a shareholder to sue for damages against a company in circumstances where the shareholder has not renounced his or her holdings. In *Crosbie; Re Media World Communications Ltd*, Finkelstein J held that a person who has subscribed for shares in a company may not, while he or she retains those shares (that is, without renouncing the contract by which the shares were acquired), recover damages against the company on the ground that purchase was induced by fraud or misrepresentation.[15]

The decision is somewhat counter-intuitive, and it has been noted by some commentators that it may have the unusual result of defeating shareholder class actions in situations where a company has subsequently entered into administration or liquidation (because, at that time, shareholders are effectively barred from changing the status of their investment). It would be unusual if a potential defendant could avoid a significant shareholder class action claim by choosing to enter into administration (and also potentially inconsistent with section 729 of the Corporations Act which allows shareholders to sue over a misleading prospectus). Nevertheless, that appears to be the present position in Australia until such time as the *Media World Communications* decision is re-visited.

Conclusion

There are a variety of factors which create a potential for a greater volume of shareholder class actions in Australia. A number of legal obstacles to the prosecution of shareholder class action claims have either recently been removed or are subject to ongoing challenges.

Already we have seen an increase in the incidence of such actions in Australia, particularly since the settlement of the GIO shareholder class action and, accordingly, the long-suspected increase in the frequency of such cases is likely to become more than just a prophecy.

Footnotes

1. ASX media release,'Share Ownership Study — 2004 Findings', 24 February 2005, viewed on 10 March 2005.

2. ASX,'2004 Share Ownership Study — Background Information', 24 February 2005, ASX, viewed on 10 March 2005.

3. Australian Law Reform Commission, *Grouped Proceedings in the Federal Court Report No 46* (AGPS, Canberra, 1988), para 65.

4. NERA Economic Consulting, *Recent Trends in Shareholder Class Action Litigation: Bear Market Cases Bring Big Settlements*, February 2005.

5. Prudential Assurance v Newman Industries Ltd (No 2) [1982] 1 Ch 204.

6. Foss v Harbottle (1843) 2 Hare 461; 67 ER 189.

7. Johnstone v HIH [2004] FCA 190 at [38].

8. See *Bray v F Hoffman-La Roche* (2003) 130 FCR 317 at [248]; *Milfull v Terranora Lakes Country Club (in liquidation)* [2004] FAC 1637 at [3]; but also see the recent decision of Mansfield J in *Guglielmin v Trescowthick (No 2)* [2005] FCA 138 which may support the existence of the threshold requirement.

9. Peta Spender, 'Securities Class Actions: A View from the Land of the Great White Shareholder' (2002) *Common Law World Review* 123 at 127.

10. See discussion in Spender, above at 128; and Julian Donnan, 'Class Action Securities Fraud in Australia', 18 *Company and Security Law Journal* 82 at 94.

11. See *Qantas Airways Ltd v Leonie Cameron* [1986] 765 FCA 1

12. See, for example, the discussion of these principles in *Trendtex Trading Corp v Credit Suisse* [1982] AC 679.

13. See *Magic Menu Systems Pty Ltd v AF Facilitation Pty Ltd* (1997) 142 ALR 198.

14. See *Magic Menu* at 206.

15. [2005] FCA 51

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.