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IN THIS ISSUE

The growing commercialization of Australia's class action regime has prompted calls for reform. This article considers two current proposals: increased court supervision and regulation of litigation funders and a review of the legal and economic impact of the continuous disclosure obligations of publicly listed companies in the context of the increasing number of shareholder class actions in Australia.

Australian Class Action Reform: Reigning in the Effects of Commercialization

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Australia's class action regime was first introduced by the Federal Court of Australia in 1992.[1] The objectives of the regime include increasing access to justice, reducing the cost of litigation and promoting the efficient use of resources by achieving finality for multiple claims.[2]

At the outset of the regime, it was anticipated that consumer claims and trade practices matters would be the main types of claims brought as class actions.[3] However, the regime has evolved significantly since that time. There has been a general upwards trend in class actions filing across a broader range of claim types. Most notably, since at least 2004, shareholder class actions have taken on an unexpected prominence and have accounted for more than half of all class action filings over the past decade. This trend has been amplified in the past two years, with shareholder class actions making up almost half of all claims filed since December 2017.[4]

The promotion of class actions has become an increasingly entrepreneurial exercise, with class actions, particularly shareholder class actions, seen as a lucrative business opportunity for funders and plaintiff lawyers. Class actions used to be funded by group members themselves or lawyers acting on a "no win, no fee" basis, since the acceptance of litigation funding by the High Court of Australia in 2006[5], funders have become a fixture in, and have had a significant impact on, the class action landscape.[6]

This is evident in the ways in which funders have been successful in shifting the boundaries of the regime to better serve their commercial objectives. For example, despite Australia's regime being an opt out model, it is now commonplace for "closed class" actions to be brought, limited to those who have signed a funding agreement.[7] Further, litigation funders have successfully pressed for the acceptance of common fund style orders. A common fund order, in general terms, involves a funder receiving a Court-endorsed funding commission from all class members who participate in a settlement or a judgment, rather than just those who have signed funding agreements.[8] The acceptance of this approach has made Australian class actions

[1] Federal Court of Australia Act 1976 (Cth) pt IVA. Since 1992, equivalent state based class action regimes have been introduced in the Supreme Courts of Victoria, New South Wales and Queensland.
[2] *See*, *e.g.*, Commonwealth, Hansard, Second Reading Speech, 14 November 1991, pp 3174-3175 (Duffy).
[3] Just prior to the regime's introduction, the Australian Law Reform Commission identified a non-exhaustive list of the types of proceedings that it envisaged might be brought as class actions. *See* Australian Law Reform Commission, *Grouped Proceedings in the Federal Court*, Report No. 46 (1988).
[4] Allens, Class Action Filing Analysis. This research is based on publicly available information in relation to class action filings between 2005 and 31 August 2018 in the Federal Court of Australia, and Supreme Courts of Victoria, New South Wales and Queensland (the Queensland's regime's commenced in 2017). This research will be published shortly. See also Allens, *25 years of class actions: where are we up to and where are we headed?* (27 March 2017).
[5] *Campbells Cash and Carry Pty Ltd v. Fostif Pty Ltd* (2006) 229 CLR 386.
[6] Allens, Class Action Fling Analysis.
[7] *Multiplex Funds Management Limited v P Dawson Nominees Pty Limited* [2007] FCAFC 200.
[8] The Full Federal Court of Australia accepted the validity of a common fund style order in *Money Max Int Pty Ltd. (Trustee) v. QBE Insurance Group Ltd* [2016] FCAFC 148.

an even more attractive proposition for local and offshore funders.

The number of competing class actions, being two or more class actions with overlapping group membership, has also substantially increased in recent years.[9] For example, this year Australian courts across different jurisdictions have had to deal with 5 competing shareholder class actions against AMP Limited.[10] As acknowledged recently by the Full Federal Court of Australia, the problem of competing class actions is one that results from "the competing self-interests of those promoting and hoping to manage these proceedings".[11] The commercialization of Australia's class action regime has prompted an inquiry by the Australian Law Reform Commission (***ALRC***), which has put forward proposed reforms for discussion, called for submissions in response and is due to deliver its final report in December this year.[12] It follows a similar inquiry last year by the Victorian Law Reform Commission in respect of the equivalent state-based class action regime.[13] Two proposals include increased court supervision and regulation of litigation funders and a possible review of Australia's continuous disclosure regime in the context of the increasing number of shareholder class actions.

Proposed Reforms Concerning Litigation Funders

Licensing Regime

While litigation funders are now an entrenched part of the class action landscape, they remain largely unregulated. Funders are not required to hold a licence to operate in Australia and are not subject to capital adequacy requirements to ensure they are able to meet the financial promises they have made in relation to the litigation. Further, beyond a requirement that funders maintain a conflicts of interest policy[14], there is little oversight of funders' conflicts of interest in their conduct of the class action and their dealings with group members.

To ensure ongoing scrutiny of litigation funders and to protect consumers of litigation funding as well as other parties to class action litigation, the ALRC has proposed that funders be subject to a bespoke licensing regime modelled on the existing Australian Financial Services Licence (***AFSL***) regime.[15] Applications for an AFSL, which in Australia is required to conduct a financial services business, are assessed by the Australian Securities and Investments Commission (***ASIC***), the corporate and

[9] Allens, Class Actions Analysis.
[10] *Wileypark Pty Ltd v. AMP Limited* [2018] FCAFC 143.
[11] *Wileypark Pty Ltd v. AMP Limited* [2018] FCAFC 143, [5].
[12] Australian Law Reform Commission, *Class Action Proceedings and Third Party Litigation Funders*, Discussion Paper No 85 (2018) ("*Discussion Paper*").
[13] Victorian Law Reform Commission, *Access to Justice: Litigation Funding and Group Proceedings*, Report (2018). The inquiry commenced in 2017 and the final report was tabled in the Victorian Parliament in June this year.
[14] Australian Securities and Investments Commission, *Regulatory Guide 248*, ASIC [248.1]. We are not aware of any enforcement action taken by ASIC for non-compliance with the obligations.
[15] *Discussion Paper*, above n 12, [3.3] – [3.12] (Proposals 3-1 and 3-2).

financial services regulator.[16] A similar licencing regime for litigation funders would likewise be administered by ASIC.[17]

Requirements for licence holders would be similar to those applicable to AFSL holders. Amongst other things, litigation funders would be required to ensure accurate communication with group members, have adequate arrangements for managing conflicts of interest, have sufficient financial, technological and human resources, and importantly, would be audited annually to ensure that the funder continues to meet the conditions of its licence.[18] The ALRC considers annual auditing to be a key plank of the licensing scheme's integrity and the potential loss of a licence an important means of incentivising compliance.[19]

More than 65% of submissions to the ALRC were supportive of a licensing regime. In recent discussions, the ALRC has indicated that it is still considering the precise form the licensing regime will take.[20]

Court Oversight of Funding Fees

In funded proceedings in Australia, it is typically the litigation funding commission that represents the largest single amount deducted from the settlement or judgment, averaging between 20 – 45 percent of the recovery sum.[21] A litigation or project management fee, or other similar impost, may be sought to be imposed in addition to the funding commission. There has been increasing concern in recent years that commissions received by funders may be excessive and disproportionate when compared to the risks taken on by the funder or lawyer and the ultimate sum recovered by the group members.

Australian courts have continued to grapple with the level of funding commissions in class actions and the extent to which they have the power to vary a commission which has been contractually agreed to between funders and group members. Currently, Australian courts have no specific statutory power to do so. While some courts have expressed the view that such a power is inherent in its supervisory and protective role,[22] the position remains uncertain[23] and is likely only to be resolved by the High Court of Australia.[24]

In such circumstances, and given the significant role that funders play in class

[16] Australian Securities and Investments Commission, *Regulatory Guide 266*, ASIC.
[17] *Discussion Paper*, above n 12, [3.7].
[18] *Discussion Paper*, above n 12, [3.3] – [3.12].
[19] *Discussion Paper*, above n 12, [3.10].
[20] Australian Law Reform Commission, Inquiry into Class Action Proceedings and Third-Party Litigation Funders: Post Submissions Seminar (Sept. 6, 2018), https://www.alrc.gov.au/sites/default/files/seminar_series_2018_10_september_2018.pdf.
[21] Victorian Law Reform Commission, *Access to Justice: Litigation Funding and Group Proceedings*, Report (2018) [8.25].
[22] *Earglow Pty Ltd v. Newcrest Mining Ltd* [2016] FCA 1433; *Blairgowrie Trading Ltd v Allco Finance Group Ltd (Receivers & Managers Appointed) (In Liq) (No 3)* [2017] FCA 330; *Mitic v Oz Minerals Limited (No 2)* [2017] FCA 409.
[23] *Clarke v. Sandhurst Trustees Ltd (No 2)* [2018] FCA 511 at [12]; *Liverpool City Council v McGraw-Hill Financial, Inc (now known as S&P Global Inc)* [2018] FCA 1289 at [148].
[24] *Discussion Paper*, above n 12, [5.50] – [5.52].

actions, the ALRC proposes that the question be put beyond doubt and that class action legislation be amended to provide the court with the express power to vary funding commissions.[25] In this context, the ALRC has also sought views on whether statutory caps should be placed on funding commissions.[26] In our view, court oversight of funding commissions on a case by case basis rather than through statutory caps is preferable, because rather than serving as a maximum, the cap may come to be seen as the default rate.[27]

Proposed Reforms Relating to Shareholder Class Actions

Shareholder Class Action Environment

As discussed above, shareholder class actions have been seen by promoters as an attractive business proposition, given the size of the potential damages claim and the difficulties in defending the claims due to the nature of the causes of action.

Indeed, in recent times, it has become a fact of corporate life that, after any significant share price drop, there is likely to be an announcement by at least one law firm (and increasingly multiple firms) that they are investigating the company's conduct and inviting shareholders to register their interest in participating in a class action. Should a class action ultimately be filed, experience suggests that the class and the company are in for years of drawn-out litigation which is usually brought to an end by a settlement.

The most common allegation in Australian shareholder class actions is that because of a deficiency in a company's market disclosure (whether that be a market announcement, offer document, accounts or something similar), shareholders either bought shares when they would not have done so but for the alleged conduct or bought shares at a higher price than they would have otherwise paid but for the alleged conduct.

These complaints then generally give rise to two specific causes of action:

a) misleading or deceptive conduct in respect of inaccurate or incomplete statements and/or a failure to disclose or correct certain information[28]; and
b) a breach of a company's continuous disclosure obligations under ASX Listing Rule 3.1.[29]

Intention, recklessness, or negligence are not necessary elements of these causes of action. It is not a defense for the company to show that those responsible for making the decision reasonably believed that the

[25] *Discussion Paper*, above n 12, [5.52].
[26] *Discussion Paper*, above n 12, [5.65] – [5.75].
[27] Allens, "Class Action Proceedings and Third-Party Litigation Funders" (Submission to the Australian Law Reform Commission, August 2018) [90] ("*Allens Submission*").
[28] *Corporations Act 2001* (Cth) s 1041H; *Australian Securities and Investment Commission Act 2001* (Cth) s 12DA.
[29] ASX Listing Rule 3.1 requires a listed entity to immediately inform the ASX once it becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities. Listing Rule 3.1 is given statutory force by *Corporations Act 2001* (Cth) s 674.

information was not market sensitive. [30] With no need to prove intent, it is relatively easy for claimants to make a claim of non-disclosure and correspondingly difficult for a company to defend such claims.

This is in contrast to other jurisdictions. The United States, for example, requires proof of an intent to deceive, manipulate or defraud to support a private right of action.[31] The United Kingdom requires dishonest admission or delay.[32]

These causes of action will only lead to damages if it can be shown that there is a causal link between the contravention and the loss. How causation is to be established is still one of the key unanswered questions in Australian class action law. There remains uncertainty as to whether each shareholder has to prove direct reliance on the contravening conduct or causation can be established by general notions of reliance by the market affecting the price at which each shareholder purchased and/or sold their share (known as market-based causation). Market-based causation is favored by class action promoters because it means that causation can be determined as a common question and claimants would not need to individually prove they relied on the contravening conduct (which would be the case if direct reliance were required).

While two first instance decisions, not in the shareholder class action, have favored market-based causation,[33] the uncertainty can only be authoritatively resolved by the High Court of Australia. It is for this reason that not one of the approximately eighty shareholder class actions filed in the past twenty years have proceeded to judgment.

Proposed Review of Legal and Economic Impacts of Continuous Disclosure Regime

In its discussion paper, the ALRC observed that:

> *…there is growing evidence of unintended adverse consequences caused by the existing framework of the Australian class action regime, coupled with the peculiar characteristics of the Australian statutory provisions concerning continuous disclosure obligations (as compared with some other cognate common law jurisdictions) and those relating to misleading and deceptive conduct. These consequences include the impact on the value of these investments of those shareholders (including the investments of the class members themselves) of the company at the time the company is the subject of the class action and the impact on the availability of directors and officers*

[30] Note that by contrast, under *Corporations Act 2001* (Cth) s 674(2B), individual directors are not personally liable for a breach of continuous disclosure obligations if they can show that they took all reasonable steps to ensure that the company complied with its disclosure obligations.

[31] *Securities Exchange Act 1934* (US) s 10(b); *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375 (1976).

[32] *Financial Services and Markets Act 2000* (UK) s 90A.

[33] *Re HIH Insurance Ltd (In liquidation)* [2016] NSWSC 482; *Grant-Taylor v. Babcock & Brown Ltd (In liquidation)* [2015] FCA 149.

insurance (D&O insurance) within the Australian market.[34]

In these circumstances, the ALRC asked for submissions as to whether a review should be conducted of the legal and economic impact of the continuous disclosure obligations of listed companies and those relating to misleading and deceptive conduct related to the unintended adverse consequences it has identified.[35]

We support the proposed review and consider that after twenty years of shareholder class action experience, an informed and balanced review is required of whether the continuous disclosure regime, and the private right of action arising from a possible breach, are serving the interests of shareholders and the broader business community.[36] In our submission to the ALRC, we identified a number of legal and economic impacts of the current regime warranting further consideration. We expressed concern that without reform, the continuation of current trends is detrimental to shareholders and the efficacy of both the class action and the continuous disclosure regime.[37]

Some of the legal and economic impacts we identified include:

(a) **Impact on shareholder value:** Shareholder class actions ultimately involve shareholders suing themselves. Although an undiversified shareholder may benefit from a compensation payment, diversified shareholders are likely to be both winners and losers across their portfolio over time. However, this redistribution comes at a cost - the significant legal and funding fees in class actions and diversion of management time away from profit generating activities hinders growth in overall shareholder wealth. Indeed, as far as we are aware, there has never been any broader consideration by the investment community as to whether shareholder class actions are in the best collective interests of shareholders.[38]

(b) **Impact on continuous disclosure obligations:** The possibility of facing a class action has elevated the importance of a listed company complying with their disclosure obligations, which is of course a good thing. However, there are also questions as to whether it has created an atmosphere of class action fear that deflects focus from other equally important issues and potentially distorts some disclosure decisions. For example, a disclosure out of an abundance of caution may inappropriately cause the share price to drop (which may in itself trigger a shareholder class action). Further, an over-disclosure has the potential to create a misinformed market in circumstances where investors assume announcements are made only in respect of things that may materially affect the share price.[39]

(c) **Impact of class actions as a form of private regulation:** In Australia, it is often said that shareholder class actions play an important role in private regulation.

[34] *Discussion Paper*, above n 12, [1.73].
[35] *Discussion Paper*, above n 12, [1.73] – [1.89] (Proposal 1-1).
[36] *Allens Submission*, above n 26, [49].
[37] *Allens Submission*, above n 26, [37] – [39].
[38] *Allens Submission*, above n 26, [44] – [46].
[39] *Allens Submission*, above n 26, [42].

However, we query whether at present this is in fact the case. ASIC ordinarily brings enforcement proceedings where there has been a degree of culpability concerning disclosure. As discussed above, the standard shareholder class action is pursued without reference to culpability. Further, every Australian shareholder class action has been settled. As such, they do not clarify the law in relation to continuous disclosure obligations in the way that a judgment or regulatory proceeding would.[40]

(d) **Impact on directors and officers insurance:** The increasing costs of class action litigation is making directors' and officers' insurance unviable. When one considers that the average shareholder class action costs are upwards of $50 million yet the D&O insurance market premium pool is only $280 million, there is a real risk that entity insurance will become limited or phased out altogether. If that happens, directors will retreat to an even more defensive crouch and the consequences of over-focus on class action risk may increase. Further, the lack of entity insurance would result in directors being named as defendants in class action suits, a prospect that would discourage qualified directors from gathering in boardrooms in Australia.[41]

Suggested Reforms

In our view, the most pressing area for reform is to limit the private right of action to circumstances in which there is a degree of management fault or culpability. We think such reform would better align with the objectives of the regime and better serve the interests of the investing public.[42]

In particular, the Corporations Act could be amended so that the private right of action requires a degree of management fault or culpability, such as intentional concealment, recklessness or negligence. This would still be less burdensome on claimants than the scienter requirements in the United States and the requirement of dishonest omission or delay in the United Kingdom. Alternatively, defenses such as due diligence or reasonable and honest belief could be made available to corporations alleged to have breached their disclosure obligations. Such defenses are already enjoyed in the United Kingdom.[43]

Consideration could also be given to other amendments to the private right of action with a view to limiting that right to shareholders who have truly suffered loss as a result of the alleged conduct. This could include limiting the entitlement to damages to shareholders who directly relied on the alleged misconduct – and would involve rejecting the market-based causation approach.[44]

Another possibility is introducing a "bounce back" provision to account for the market correction that often follows the sharp fall of a share price. A "bounce back" provision caps damages at the difference between the price paid for the share and the average price of the share in the period following the corrective disclosure (and not the price of the share immediately following the

[40] *Allens Submission*, above n 26, [43].
[41] *Allens Submission*, above n 26, [48].
[42] *Allens Submission*, above n 26, [52].
[43] *Allens Submission*, above n 26, [52].
[44] *Allens Submission*, above n 26, [53].

disclosure). The "bounce back" provision in the United States, for example, looks at the average price in the 90 days following disclosure.[45]

In our view, the disclosure obligations themselves should remain largely untouched. However, potential reforms could include giving statutory definition to what is a "material" effect on a share price such that immediate disclosure is required. The commonly-accepted rule of thumb that any change in price of more than 5% is material could be adopted by the legislature.[46]

Unsurprisingly, the ALRC reported that stakeholders were split down the middle as to the need for a review. In particular, Australia's corporate regulator ASIC has maintained that shareholder class actions "help to democratise access to justice by addressing the power imbalance between shareholders and defendants"[47] and improve corporate accountability. The ALRC is still deliberating on the need for the review.[48]

Conclusion

The class action regime in Australia plays a critical role in our civil justice system. In the twenty-five years since it was first introduced, it has "successfully delivered access to justice to claimants who have suffered loss in circumstances in which seeking individual redress would not have been possible or practical".[49] However, as the regime evolves in ways unforeseeable at its outset, particularly in shareholder class actions, it is important that a balance is maintained between the interests of claimants and defendants. In our view, the reforms discussed in this article help build a system of checks and balances that protects the interests of those whom the regime was designed to serve and ensures that it continues to deliver justice fairly and efficiently.

[45] *Allens Submission*, above n 26, [53].
[46] *Allens Submission*, above n 26, [54].
[47] Australian Securities and Investments Commission, "Australian Law Reform Commission Inquiry into class action proceedings and third-party litigation funders" (Submission to the Australian Law Reform Commission, August 2018) [48].
[48] Australian Law Reform Commission, Inquiry into Class Action Proceedings and Third-Party Litigation Funders: Post Submissions Seminar (Sept. 6, 2018), https://www.alrc.gov.au/sites/default/files/seminar_series_2018_10_september_2018.pdf.
[49] *Allens Submission*, above n 26, [7].

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