

CURRENT SHAREHOLDERS CLAIM ISSUES

1. INTRODUCTION

Over the last ten years, there have been thirty multiparty shareholder claims in Australia:

- (a) nine of which were filed and are now settled;¹
- (b) one of which was settled without filing;²
- (c) one of which was withdrawn due to the liquidation of the representative,³ one stayed⁴ and one struck out;⁵
- (d) four of which have been filed and are not yet concluded;⁶
- (e) four of which are proceeding by way of proofs of debt;⁷ and
- (f) nine of which are announced, but not yet filed.⁸

The ten settled claims achieved settlements in the following bands:

4 between \$10m - \$15m
2 between \$15m - \$50m
0 between \$50m - \$100m
4 over \$100m

Over the last four years, claim numbers have increased, principally due to illiquidity in the debt markets,⁹ with claim numbers as follows; 2007 (five); 2008 (six); 2009 (five) and 2010 (five).

The two main issues that need to be addressed currently in shareholder claims are:

- (a) how ought the five or so claims that proceed each year be chosen; and
- (b) how are they best resolved.

¹ GIO, Aristocrat, Multiplex, Sons of Gwalia, AWB, Village Life, Concept Sports, Media World and Telstra.

² Downer.

³ Evans and Tate

⁴ National Mutual Life

⁵ HIH

⁶ Centro Properties, Centro Retail, Credit Corp and OZ Minerals.

⁷ Allco, Octaviar (MFS), ION and ABC.

⁸ Transpacific, Gunns, WDS, Babcock & Brown Power, GPT, Sigma Pharmaceuticals, Elders and Nufarm. Arasor did not proceed due to insufficient claim size.

⁹ For example, Centro Properties, Centro Retail, OZ Minerals, Allco, Octaviar, ION and Babcock and Brown Power.

IMF#367774v1

2. CHOOSING THE CLAIMS TO PROCEED

2.1 Generic Disqualification Factors

The investment decisions taken by litigation funders in respect of shareholder class actions are made within a risk management framework which identifies and separately assesses risks associated with the class action procedure itself, liability, causation and quantum of loss issues, the enforceability of any judgment or settlement and the overall commercial viability and manageability of the proposed litigation.

As an initial check, IMF assesses the proposed class action against a range of disqualifying factors identified from IMF's experience. If any of these exist, the claim is immediately rejected. Disqualifying factors include:

- (a) liability evidence that isn't consistent with reprehensible conduct, irremediably too weak, too dependent upon oral evidence or which requires a factually-rich and complex forensic inquiry to identify;
- (b) a clear risk that, on the best possible case for the claimants, their casually connected loss is likely to be less than an amount which would make the project commercially viable or that causation may not be able to be established at all;
- (c) that the likely cost of the class action (including all potential adverse cost orders) is too large relative to the likely settlement or judgment making funding the litigation commercially unviable; and
- (d) a lack of confidence in, or transparency concerning, the proposed respondent's (or respondents') capacity to meet any judgment or pay a reasonable settlement.¹⁰

The statutory causes of action provided in the continuous disclosure regime have a number of intrinsic factors:

- (a) there is no need to prove intentional wrong doing;
- (b) it is unlikely to be required to prove each class members' individual reliance upon a misrepresentation;¹¹ and

¹⁰ IMF has a specific funding criteria in respect of shareholder actions being that the company must have at least \$100 million capitalisation post disclosure or the likelihood of sufficient insurance cover.

¹¹ As distinct from proving that the misrepresentation caused the market in the relevant securities to be inflated which thereby caused loss to all purchasers in the period the market is proved to be inflated. This is known as the Market Reliance Theory. This was a live issue in the Aristocrat class action but the proceedings settled before the Court was required to rule on whether causation can be established on the basis of this theory under Australian law.

- (c) the claims are determined in large part on publicly-available evidence, including documents filed with the Australian Securities Exchange and analysts reports.

Although IMF's protocols require claims to be viable on a stand-alone basis, IMF may entertain applications for funding for matters which may serve to develop precedents in relation to liability, causation and quantum which could be expected to enhance claimants' rights and facilitate the efficient and effective conduct of claims arising under the continuous disclosure regime.¹²

If the proposal does not fall within any of the disqualifying factors, IMF then conducts a thorough due diligence in respect of the potential class action. This process is rigorous and scrupulously applied to all potential funded litigation as IMF has no interest in funding claims which lack merit or are otherwise unlikely to be successful.

2.2 Specific Shareholder Class Action Funding Guidelines

The primary causes of action relied upon in shareholder claims are breaches of the continuous disclosure regime and the prohibition on misleading and deceptive conduct.

Obviously sufficient evidence of each element of the cause of action or actions relied upon must be available to the funder during the due diligence process. The following discussion, however, focuses on three of these elements, being: (a) the materiality of the non-disclosed information in relation to the price or value of the relevant securities, (b) the causal link between the non-disclosure and the pleaded loss, and (c) the quantum of the losses suffered by the group members.

One of the principal guidelines in assessing shareholder claims for funding is to look at the market's reaction to the information once it is disclosed. Usually the information under examination is negative to the price of the securities.

If the drop in the securities' price upon disclosure is material¹³ and the drop is unlikely to be referable to any other information not the subject of the alleged contravention, then *prima facie* the funder has cogent evidence that:

- (a) the non-disclosed information was material to the price or value of the securities;¹⁴

¹² Although not a class action, a good example is the funding of the claims by Mr Luka Margaretic against Sons of Gwalia Ltd (then subject to a Deed of Company Arrangement). The litigation resulted in a landmark decision of the High Court of Australia which held, by a 6-1 majority (Callinan J dissenting), that a shareholder with a claim against a company for misleading or deceptive conduct can prove in the administration or liquidation of the company and rank *pari passu* with the claims of other unsecured creditors: *Sons of Gwalia Limited v Margaretic* [2007] HCA 1.

¹³ That is, the price drops by an amount of ten percent or more as a result of the disclosure.

¹⁴ Section 674(2) (c)(ii) of the Corporations Act.

- (b) the failure to disclose the information in a timely manner caused the market in the securities to trade at a price higher than it would have traded at had the information been disclosed in a timely manner;¹⁵
- (c) the price or value of the securities was inflated from the time of the failure to disclose until the material information was disclosed (the “**Inflation Period**”)¹⁶ by an amount referable to the price drop when disclosed;¹⁷ and
- (d) the quantum of the loss can be estimated, in a broad sense, by reference to the inflation in the price or value of the securities caused by the contravention and the number of the securities purchased in the Inflation Period and still held by group members at the conclusion of the Inflation Period.¹⁸

If the drop in the price or value of the securities is immaterial after disclosure,¹⁹ then there will be limited interest in funding any claim unless causally connected loss and materiality can be proven in some other way.

Other selection guidelines for shareholder class actions and their relevance include:

- Trading volumes and analyst coverage. These factors bear on the scale of potential losses and evidence of an efficient market in the securities concerned.
- The market capitalisation of the company. This bears on the company’s capacity to meet any settlement or judgment.
- The likely depth and complexity of the forensic inquiry to prove the contravention and the causally connected loss.
- The market reaction to the alleged misconduct, which may be judged on a spectrum from careless to heinous. IMF’s test is “reprehensibility.”

This last factor is central to case selection. Whilst the Corporations Act doesn’t require proof of intentional wrongdoing;²⁰ IMF requires evidence of the likelihood that the directors knew information that was likely to be material and then chose not to disclose the information.

¹⁵ Another of IMF’s funding guidelines is that the price drop was at least by a quarter of the pre disclosure price.

¹⁶ Another of IMF’s funding guidelines is that the Inflation Period must be less than a year in duration.

¹⁷ Another of IMF’s funding guidelines is that the book build claim value ought to be estimated at greater than \$30m before support for the claim is sought.

¹⁸ This is one of the four or five loss methodology theories that will remain a theory until this area of the law obtains some certainty from an appellate court judgment. Until then, this will be fertile ground for debate between lawyers.

¹⁹ An example of a case in which the applicant was unable to demonstrate that selective disclosures of the relevant information to the market caused the share price to decline. See: *Taylor v Telstra Corporation Limited* [2007] FCA 2008 at [79].

²⁰ Section 674 simply requires causally connected loss from non disclosure of material information and section 1041H simply requires causally connected loss from misleading or deceptive conduct.

A good example of this test in operation is where the company makes a forecast as to its future earnings. If it is likely that it had no reasonable basis for the forecast, it may be in breach of section 1041H of the Corporations Act but without more, IMF would not provide funding. For IMF to fund the claim, there would need to be evidence of facts known to the directors which are materially inconsistent with the proposed forecast and the directors in any event choosing to make, or leave in place, the forecast. In other words, non disclosure of material information known to at least one member of the board. IMF requires “reprehensible” conduct; not simply non disclosure or misleading representations.

Whilst this is not legally required, if this test is adopted in the choice of shareholder claims, it will ensure only the most egregious conduct has a spotlight placed upon it for the benefit of damaged shareholders and the market in general.

3. EFFICIENT RESOLUTION IS IN ALL PARTIES INTERESTS

Funded shareholder claims do not suffer from lack of resourcing or inadequate legal representation. One must look deeper for reasons why most claims take three to four years to conclude by way of settlement only after millions of dollars have been spent on legal costs.²¹

Indeed, there are examples of an eight figure shareholder claim settling without the need for court proceedings and a nine figure class action being the subject of consent orders consistent with the costs of each side being less than \$2 million and the trial being heard within about six months of the claim being filed.²²

It can be done.

Once it is accepted that the funded representative is willing and able to conclude the claim by proceeding to trial and judgment, it is in all parties’ interests to seek to resolve the claim by way of settlement as efficiently as possible.²³

Indeed, recent reforms to civil procedure legislation both Federally and in many States requires the parties, the lawyers, the funders and insurers to seek just, efficient and effective resolution of claims.²⁴

²¹ The GIO, Aristocrat and Multiplex claims cost each claimant over \$10m and each company’s costs are likely to have been greater than the claimant’s costs.

²² Wingecarribee Shire Council v Lehman Brothers (Federal Court, Sydney Registry No. NSD 2492 of 2007 before Rare J).

²³ Unless either party reasonably forms a view that the other is either incapable or unwilling to objectively value the claim and settle it at a reasonable figure.

²⁴ Section 37M of the Federal Court of Australia Act 1976 as amended by Access to Justice (Civil Litigation Reforms) Amendment Act 2009; Order 1, Rule 4B of the Western Australian Supreme Court Rules (1971); Section 5(1) of the Queensland Uniform Civil Procedure Rules 1999; Rule 1.14 of the Victorian Supreme court (general Civil Procedure) Rules; and Section 56 of the NSW Civil Procedure Act (2005).

Funding for shareholder claims has addressed the previous power imbalance between the parties and enabled settlements.²⁵

Delay and diversion tactics are now less prevalent for a number of reasons, including:

- (a) interlocutory judgments concerning the class action process have created more certainty;
- (b) lawyers who are frequently retained by applicants²⁶ and respondents²⁷ have become more knowledgeable in the procedural and substantive issues that need to be addressed; and
- (c) Judges have become more able and willing to case manage the process to achieve the overarching objectives of the Court.

More importantly, however, there is evidence of respondent companies realising that:

- (a) the claim values may turn out to be more than the limits on their insurance policies;
- (b) the class members invariably include institutional investors who are current or potential shareholders of the respondent company; and
- (c) the civil justice system is expensive, time consuming and capable of diverting internal resources and equity market focus from the companies' business.

For all of these reasons, and others, it is in all parties' interests to seek to resolve shareholder claims as efficiently as possible.

4. **COMPANY MANAGEMENT COMMUNICATIONS**

The first and most important factor in resolving shareholder claims efficiently is the companies' management creating positive communication channels between company management chosen to manage the claim and the board, the major shareholders, the company's insurers and lawyers and the claim's funder.

How each of these communication channels are created and utilised by company management has the capacity to materially affect the process and outcome of the claim.

²⁵ Funding can be lawyers agreeing to a speculative pricing policy or third party funding.

²⁶ Maurice Blackburn, Slater and Gordon and William Roberts

²⁷ Freehills, Mallesons Stephen and Jaques and Allens Arthur Robinson.

Management and the Board

From notification of the claim to management, the board will need to form a view as to the legitimacy and value of the claim and address:

- (a) any necessary changes to management;²⁸
- (b) whether the claim's value makes the likely financial outcome the insurer's issue within the policy limit or a joint issue where the claim's value exceeds the policy limit; and
- (c) shareholder relations.

The last two of these issues are addressed below.

Management and the Insurer/s

It is important for management to interact efficiently with the insurer directly in order to understand:

- (a) whether there is Side C cover, which covers the company, or whether only directors are covered;
- (b) the processes through which it is proposed the insurer will indemnify in respect of costs²⁹ and hopefully liability;³⁰
- (c) who is to choose the lawyers who will act for the company and who is to provide the instructions; and
- (d) the limit of the cover and how the company as insured and the insurer are to efficiently determine the claim's value and achieve its resolution.³¹

There is a tendency for insurers to delay granting indemnity, creating uncertainty for the insured company and the lawyers acting for the company as a prudent uninsured prior to the grant.³²

²⁸ Intentionally left blank.

²⁹ Refer to CGU Insurance Limited [2005] HCA 16

³⁰ This will be assisted by the shareholder claims not alleging any intentional wrongdoing.

³¹ At least in Victoria, this is also likely to be a duty of the insurer if the Victorian Procedure Bill 2010 passes through the Victorian Parliament.

³² The contractual mechanism to alleviate this tendency is the duty of good faith.

Even when indemnity is granted, until the claim is quantified above the insurance limit:

- (a) the company has a motive to leave the claim to the insurer; and
- (b) the claim only has one boss when in fact it ought to have two.

Insurers are repeat players, when companies, hopefully are not.

The existence of insurance which potentially covers the shareholder claim is the “**First Settlement Factor.**”

Management and the Institutional Shareholders

Funded claims almost certainly follow material destruction of shareholder value following the surprise disclosure of information that is publically alleged to be in breach of the Corporations Act. If the claim has passed appropriate due diligence, institutional shareholders are likely to be angry about being deceived and many will have exited their investment. Others will continue to retain their investment, or a portion of it, and will need to understand:

- (a) why future information disseminated by management ought to be trusted;
- (b) what exposure the company has to the claim net of insurance; and
- (c) whether they ought to sign a funding agreement with the funder having regard to the effect of the claim on the share's value and the value of the claim.

Management and the Company's Lawyers

If the insurer is prepared to pay the costs in respect of the claim, even if it delays providing indemnity, it will want to provide the instructions to the lawyers. Management will need to be sensitive to the differing interests of the company and the insurer, particularly where:

- (a) the limit of the policy may not be sufficient to meet all of the claim; and
- (b) the manner in which the disclosure issues are addressed will affect shareholder relations.

Shareholder claims are unusual in the sense that many institutional shareholders have, or may wish to have in the future, a continuing financial interest in the company. The company, as a listed entity relying upon equity market support for its capital management, has a similar interest.

If the company's lawyers have experience in shareholder claims, they will be aware of these dynamics and set about valuing the claim as efficiently as possible.

Management and the Litigation Funder

Management will need to decide whether they engage directly with the litigation funder to facilitate resolution of the claim.³³ This invariably involves, as a first step, the swapping of information pursuant to a Deed of Confidentiality rather than within the Court process, including:

- (a) company documents materially relevant to the claim; and
- (b) relevant trading data for class members.

This disclosure by both parties enables the valuation of the claim by both parties; a process discussed below.³⁴

5. VALUING THE CLAIM

5.1 Pre Disclosure Valuation

During the due diligence phase prior to the claim being determined appropriate for funding, many factors going to the value of the claim are assessed, including:

- (a) the information it is alleged that is material to the price or value of the companies shares that wasn't disclosed (the "Material Information");
- (b) the period during which it is alleged that the Material Information was known to the company and not disclosed (the "Period"); and
- (c) an estimate of what the shares of the company would have traded at during the Period had the Material Information been disclosed at the commencement of the Period³⁵, thereby enabling an estimate of the inflation in the shares caused by the non disclosure (the "Inflation").

Once the risks associated with the claim are considered acceptable by the funder to assume, the book-build phase will commence with notification to as many purchasers of the company's shares in the Period as possible³⁶ of the opportunity to join the class. During this process,

³³ IMF is retained by the class members in shareholder class actions to, amongst other matters, facilitate non litigious means of resolving the claims.

³⁴ In sections 5.3 and 5.3.

³⁵ Refer to section 2.2 above.

³⁶ Funders are currently not permitted to use the share register: IMF (Australia) Ltd v Sons of Gwalia Ltd (Administrators Appointed) [2005] FCAFC 75

funding will be conditional upon there being sufficient purchases in the Period becoming the subject of a litigation funding agreement to make the claim commercially viable.

The size of the “Book” (the “**Second Settlement Factor**”) depends upon the strength of the case, the Period, the volume of trades in the Period, the number of institutions in the stock and their support and the Inflation.

Until the claim is commercially viable, it has no value³⁷. After then, the claim’s value before discounts may be estimated as the total Inflation paid by shareholders who sign funding agreements on purchases of shares in the Period held until the conclusion of the Period³⁸ (the “Pre Disclosure Claim Valuation”).

5.2 The Confidentiality Deed

The Pre Disclosure Claim Valuation is merely based upon public information derived predominantly from Australian Securities Exchange announcements and analysts’ reports. Further information relevant to the claims’ value is needed by the class members before they have sufficient information to seek to settle their claims; principally documents going to the discount that is acceptable in a settlement to address the risks of failing to be able to prove:

- (a) The Material Information was required to be disclosed and the duration of the Period;
- (b) Non disclosure of the Material Information caused loss³⁹; and
- (c) The quantum of the Inflation.⁴⁰

The “Risk Discount Documents”

The principal information necessary for the Company to settle the class members’ claim are their names⁴¹, details of their shareholding at the commencement of the Period and their subsequent trades (the “Trade Data”).

37 It is unlikely any company would pay compensation until it is faced with a funded claim.

38 There are other loss calculation methodologies to estimate the Inflation in the Period, with this method being a conservative method in the pre claim phase.

39 The test for causation is uncertain. Respondent companies say direct reliance is needed and institutions won’t prove whereas shareholders say that market reliance is sufficient and, if direct reliance is necessary, institutions will prove. Until the causation issue is resolved definitively by the legislature or the High Court, uncertainty will impact on settlements (the “**Third Settlement Factor**”).

40 The methodology for calculating the quantum of causally connected loss is also uncertain. At one extreme there is the no transaction case (purchase price less sale price, if any) and at the other extreme there is the inflation at date of purchase less inflation passed on (i.e. set off). These and other issues, including matching of purchases and sales, create uncertainty in quantifying loss. (the “**Fourth Settlement Factor**”).

41 The names aren’t technically necessary for valuing the claims as there is only limited capacity to reconcile the names with the share register, but are relevant to assessing the effect of the claim on shareholder relations. Normally the names would not be provided until the defendant has agreed to a confidentiality regime which protects the use of the names.

The class members and the company have legitimate interests in receiving disclosure of the Risk Discount Documents and the Trade Data, respectively provided disclosure is conducted confidentially and for the sole purpose of facilitating resolution of the claims.⁴²

No legitimate settlement will be achieved until and without this mutual disclosure.

Without the agreement of the company, the Risk Discount Documents will only be received after inefficient, expensive and time consuming discovery by the company within the adversarial litigation process.

Without the agreement of the class members, the Trade Data of all class members other than the applicant representative will not be disclosed until after the trial of the common issues and only then if the company is prepared, after losing the trial against the representative, to litigate against each and every class member individually.

There is a mutual interest in disclosure as there is a mutual interest in resolving the claims efficiently. The company and the class members and funders have limited interest in submitting to inefficient, expensive and time consuming discovery.

Accordingly, Confidentiality Deeds, rather than submitting to discovery, are likely to be entered into sooner rather than later after the claim is made.⁴³

5.3 Post Disclosure Valuation

The representative, its lawyers, and other material stake holders will have the benefit of reading the Risk Discount Documents relevant to:

- (a) the materiality of the information;
- (b) the knowledge by the company of the information; and
- (c) quantification of the Inflation.

This will enable the lawyers for the representative to obtain informed instructions, after receipt of expert opinion, relevant to the Risk Discounts referable to the claims valuation.

Similarly, the company will have the benefit of the Trade Data, together with the Risk Discount Documents, to enable it to be informed of the total value of the claims (the "Post Disclosure Valuation").

⁴² This is invariably done pursuant to a Deed of Confidentiality cloaking information swapped by both parties in confidence.

⁴³ This occurred in Downer and the claim was resolved without the need for legal proceedings.

The Claimants and the company will, no doubt, have a different view of the Post Disclosure Valuation, but at least each will be armed with sufficient information to either do a deal or fight it out.⁴⁴

In any event, both parties, I submit, are better off. There is no justification for delay and diversion.

6. CONCLUSION

Funders, particularly those organised as public companies such as IMF, must primarily assess applications for funding by reference to legal, process and commercial criteria when determining whether a proposed shareholder class action should be funded. In doing so, funders perform an essential filtering function by separating, from the class action proposals that are submitted to them, those actions that will proceed from those that will not. This necessarily means that not all valid claims will make it to court, let alone be legitimately resolved.

However, market participants themselves also play an important role in determining which actions will go forward through the bookbuild process. If, for example, sufficient shareholders are unwilling to join a proposed securities class action, the action simply will not proceed. Hence the claimants themselves ensure that the funder's financial resources are allocated to those claims with the greatest likelihood of maximising recoveries from those participants in the market whose contraventions have caused the greatest loss.

Opt in funded class action litigation shifts case selection from lawyers to the market participants who have actually suffered material losses. In doing so the underlying policy objectives of the market protection legislation (deterrence of prohibited behaviour, effective enforcement of statutory norms and compensation for those harmed) are given effect. In a real sense, the market chooses the class actions that will be taken since the Full Court's decision in *Multiplex*.⁴⁵

The development of litigation funding has vastly improved the prospects for effective enforcement of the market protection legislation in Australia and, in the process, has facilitated much greater access to justice for market participants. However, real access will require fundamental reform of the civil justice system itself to make class actions quicker, cheaper and more efficient to resolve.

⁴⁴ Any "deal" with a closed class will be dependent upon addressing the free rider factor, being the risk of a material level of claim being made in addition to the claims of the funded class members. Opening of the class may be necessary to settle. This existence of free riders creates the "**Fifth Settlement Factor**".

⁴⁵ *Multiplex Funds Management Ltd v P Dawson Nominees Pty Limited* [2007] FCAFC 200.

In the meantime, it is in all parties' interests to seek to resolve shareholder claims by way of settlement as effectively as possible.⁴⁶

The First to Fifth Settlement Factors need to be efficiently addressed and resolved by the companies' management through the communications with stakeholders identified in section 4 above.

This will necessarily involve a valuation of the claims and then resolution by settlement or judgment, efficiently or via our civil justice system.

Given the last ten year history of shareholder claims, I expect in the future settlements to be the norm and efficiency of resolution to increase. Let's hope so.

7 September 2010
John Walker
Executive Director

⁴⁶ Even where the company considers it will win the litigation as it will be able to obtain the trade data, value the claim, identify what the claimants consider the claim is worth and then proceed to trial in a more efficient manner than otherwise possible.