Business Council of Australia

SUBMISSION

Submission to the Parliamentary Joint Committee on Corporations and Financial Services on litigation funding and the regulation of the class action industry

June 2020

ABOUT THIS SUBMISSION

This is the Business Council's submission to the Parliamentary Joint Committee on Corporations and Financial Services (**Committee**) on litigation funding and the regulation of the class action industry.

The Committee has been asked to report on whether the present level of regulation applying to Australia's growing class action industry is impacting fair and equitable outcomes for plaintiffs. This submission mainly comments on items 8 and 9 under the Parliamentary inquiry's terms of reference.[1]

Key recommendations

The Business Council recommends the following actions to restore balance in the law and reduce the costs of opportunistic shareholder class actions:

- Retain the Treasurer's temporary restrictions on liability for breaches of continuous disclosure obligations under 674(2) of the Corporations Act, either in their current form or as a due diligence defence.
- Introduce a limited due diligence defence that allows listed entities to defend claims under section 1041H of the Corporations Act relating to 'misleading and deceptive conduct' (and related sections of the law that impose strict liability) where they took 'reasonable steps'.
- Include an equivalent 'reasonable steps' defence for directors and officers under section 180 of the Corporations Act. Such 'reasonable steps' defence could be included in section 180 either through a new provision that is equivalent to the 'reasonable steps' defence in section 674(2B) or through aligning the scope of the business judgment rule defence in section 180(3) with section 674(2B)

MAIN SUBMISSION

This submission is primarily concerned with the increasing prevalence of securities class actions under existing corporations law and the disproportionate costs this imposes on Australian companies and the wider economy.

Class actions play an important role in providing individuals with access to justice when there is corporate wrongdoing and can make the legal system more effective. However, the current use of class actions in relation to continuous disclosure obligations is excessive and presents significant risks to economic growth.

Recent shareholder class actions have imposed substantial costs on business and directors estimated at over $1.8 billion. This is causing a dramatic rise in directors and officers' insurance premiums – an average rise of 118 per cent in 2019, with the most extreme rise at 600 per cent. The average rise for the first quarter of 2020 is 225 per cent (Marsh).[2] Many

1.https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Litigationfunding.

2. Marsh, Submission to the parliamentary inquiry, No.3, June 2020.

insurers have left the Australian market and it is being reported that insurance is becoming unavailable for some companies.

If left unchecked, the rise in shareholder class actions will see costs continue to rise and highly capable individuals deterred from taking on board duties due to the unavailability of adequate insurance. It will also create risk-averse, compliance-oriented companies with harmful long-term impacts on economic growth and job creation. This would clearly also be contrary to the long-term interests of the growth of the Australian economy and investors' returns on equity.

These actions, frequently led by litigation funders, utilise the strict liability regimes in the Corporations Act for continuous disclosure (under section 674) and misstatements (under section 1041H and equivalent provisions). The current regime holds directors and officers of ASX-listed entities to an unreasonable standard if they do not accurately predict future events.

Under the Treasurer's temporary amendments, a breach of continuous disclosure obligations (section 674(2) for ASX-listed entities) now requires 'knowledge, negligence or recklessness'. This means that ASX-listed entities cannot be sued for continuous disclosure issues (and should not face civil penalties or class actions based on section 674(2)) without proof of this fault-based element.[3] It is a timely and reasonable change in this unprecedented COVID-19 era. It complements helpful guidance released by the ASX on the application of the ASX listing rules during the COVID-19 pandemic.[4]

This change will help limit opportunistic legal action that would otherwise hold back companies in their efforts to carry on business operations and keep Australians in jobs. In essence, it returns the provision to the continuous disclosure standard that operated effectively before 2001.

There is a strong case for making this change permanent. In addition, there is a need for this Parliamentary inquiry to examine other provisions in the Corporations Act that unduly heighten the costs and risks of class actions and to test whether they are operating in the public interest, including:

- the strict liability regime for misleading statements under section 1041H (and related sections of the Act that also impose strict liability);
- criminal actions and ASIC prosecutions; and
- private rights of action.

Our post-COVID-19 economic recovery must be jobs-focussed, and that means businesses should be focussed on getting Australians safely back to work and creating new opportunities, not contesting opportunistic class actions. The post-COVID-19 environment will be characterised by unprecedented levels of economic uncertainty. In this climate, a strict liability disclosure regime becomes even more untenable.

Strong continuous disclosure rules are essential for fair and efficient markets. This submission does not argue for any watering down of continuous disclosure obligations. ASX-

3. Corporations (Coronavirus Economic Response) Determination (No. 2) 2020
4. ASX Compliance Update, 31 March 2020

listed entities have a duty to comply with these obligations and act responsibly to keep markets informed.

Rather, this submission is concerned with ensuring that regulation to protect investors and markets from inadequate disclosure is proportionate, clear and efficient, and supports a growing, productive economy that creates and sustains jobs.

Directors and officers of listed companies that make decisions to provide information to the market, often under highly uncertain conditions, should have appropriate protections from liability when they have applied diligence and provided information in good faith. Although directors and officers have a limited due diligence defence (under section 674(2B)) to a breach of section 674(2A) under the continuous disclosure regime, no such defence exists in relation to an alleged 'stepping stones' breach of the duty of reasonable care under section 180. This outcome is inconsistent from a policy perspective and creates anomalous outcomes. A limited due diligence defence should also exist under s1041H in relation to misleading and deceptive conduct (and related sections of the law that impose strict liability).

Overreach in the law is not conducive to better disclosure and better functioning markets. It makes companies wary about issuing guidance of any kind, including issuing guidance where they are not required to do so by law, which in turn detracts from the objective of having an informed market for publicly traded securities. It imposes additional costs on the system from higher legal costs and payments to litigation funders. It creates a zero-sum game for investors who are ultimately required to bear these additional system costs through higher insurance premiums or payments to other shareholders for disclosure breaches.

Consideration should also be given to whether:

- there are forms of conduct where enforcement under section 674(2) and section 1041H (and related sections of the law that impose strict liability) should be limited to ASIC, to ensure action is taken in the public interest
- there should a duty on the court to appoint a contradictor when considering the fairness of the fee arrangement and split of proceeds
- a cap should be implemented on the upper limit of liability for directors/the company for breach of continuous disclosure obligations and misleading and deceptive conduct.

This Parliamentary inquiry provides an opportunity to draft sound, long term provisions in the Corporations Act that ensure markets and investors are well informed and that directors and officers, and investors, are protected from unfair and unreasonable costs and penalties under a fair and proportionate regulatory framework.

With the Treasurer's temporary changes expiring in November and the Parliamentary inquiry reporting in December, the temporary provisions may need to be extended until permanent reforms can be introduced.

THE PRESENT AND POTENTIAL FUTURE IMPACT OF CLASS ACTIONS ON THE AUSTRALIAN ECONOMY

This section responds to terms of reference (9) 'The present and potential future impact of class actions on the Australian economy'.

Growth in class actions

There has been significant growth in shareholder class actions in recent years. The Allens 2020 Class Actions Risk report finds that shareholder class actions accounted for almost 50 per cent of all filings in 2017 and 2018. This fell to 23 per cent of all filings in 2019, partly due to a rise in consumer class actions – many as a result of the Royal Commission into Banking and Financial Services.

In December 2019, Marsh made the following conclusions[5]:

- There has been a four-fold increase in the average number of securities class action claims per year over the last 10 years.
- The average class action seeks between $50 million and $75 million in compensation, with a number of ASX shareholder claim settlements exceeding A$100 million.

This has seen significant transfer of wealth to those who promote the claims and the defendants – over $1.8 billion in payouts so far.

Impact on Directors and Officers insurance premia

Class actions are putting major stresses and pressures on the system and on the insurance industry.

There is a serious problem emerging with the price and availability of Directors and Officers insurance (**D&O Insurance**). Law firms within the Business Council's membership report their clients are facing both an increase in the cost of D&O Insurance and a reduction in coverage. The reason given is that the insurers are being forced to reassess and reprice their products in light of class action pay-outs. This is the case even though directors and officers are infrequently joined as parties to class actions against the companies they govern.

Companies often settle a claim before going to court in order to avoid legal costs and reputational damage, even if they do not admit liability. This is a pragmatic decision based on the likely cost and risk of the litigation, rather than the merits of the case against them. This decision is commonly at the behest of the company's insurer.

In that sense, the current state in respect of class actions is distorting the insurance market and a more efficient market could be achieved by ensuring that class actions are better-grounded.

Some insurers are no longer prepared to bear the costs of shareholder class actions and have exited the Australian market. It is being reported that insurance is becoming unavailable for some companies.

Marsh[6] reports that D&O Insurance premiums rose an average by 118 per cent in 2019, with the most extreme rise at 600 per cent. The average rise for the first quarter of 2020 is 225 per cent. Premiums are now between $5 million and $10 million (up from $500,000 - $800,000) for coverage of between $100 million and $200 million. Some industries are paying up to $15 million. Excesses have also grown to upwards of $100 million.

For the years prior to 2019, Marsh estimated the average rise in premiums was 250 per cent.

5. Marsh JLT Speciality, The D&O Insurance Wave: Staying Above Water, December 2019.
6. Marsh 2020

D&O Insurance premiums for Side C insurance, which covers a publicly-listed company's liabilities for securities market conduct breaches, have sky-rocketed. Many companies going through the insurance renewal process report being asked to pay significantly higher costs or are not being offered insurance at all. Companies currently facing a class action are finding it especially hard to get insurance, even if the new policy isn't required to cover historical matters.

The D&O Insurance premium increases are also flowing through to higher management liability package policies used by small businesses and not-for-profits[7] and are in addition to rises in other professional indemnity policies.

Difficulty retaining and attracting directors

Company directors are currently subject to over 700 pieces of legislation which impose various obligations on directors and which create exposure to personal liability.[8]

Companies that are not able to access Side C D&O Insurance for securities class actions, or decide not to take up Side C insurance, will find it difficult to attract and retain directors to those boards.

Individual directors will be concerned about the prospect of a class action being launched against them personally rather than the company. This is especially the case for mid-caps in the ASX 200 and ASX 300 companies, where potential directors will be concerned about the ability of the company to stand behind them and bear the cost of a securities class action.

Risk aversion in ASX-listed entities

An overly-zealous class action framework creates risk aversion and adds to the growing regulatory burden on boards. It redirects attention and resources away from growing the business and creating jobs. Companies may decide not to list on the ASX to avoid the risk of a shareholder class action.

Investors, workers and customers all bear the cost

Investors bear the costs of excessive insurance premiums and/or class action pay-outs through lower returns. However the 'incidence' of these costs is also spread more widely across employees, consumers and local communities, depending on the extent to which those costs are passed through the system and impact on jobs and wages, prices and consumer choice.

Banking and finance sector

The Allens 2020 Class Action Risk Report identifies that between 2017 and 2019, the companies in Australia most likely to face a class action were those in the banking and financial services sector, which accounted for 25 per cent of all class action filings. Further, it is increasingly common for class actions to be commenced off the back of regulatory action by ASIC and other regulators, so that the company is facing both regulatory enforcement and a related class action. Recently that activity has been driven mainly by consumer claims

7. Marsh op cit.
8. King & Wood Mallesons, Analysis of Australian Corporate Governance for the Business Council of Australia, 30 January 2019, p32.

arising from the Royal Commission, however, a number of shareholder class actions have also been launched. This creates an additional burden on the banking and finance sector, which must deal with shareholder class actions and enforcement by ASIC, that risks diverting the focus of the banks from providing loans and other services that the economy needs to invest and grow.

FACTORS DRIVING THE INCREASING PREVALENCE OF CLASS ACTIONS IN AUSTRALIA

This section responds to terms of reference (8) 'factors driving the increasing prevalence of class actions in Australia'.

Strict liabilities under the Corporations Act

The strict liabilities under the Corporations Act overreach in their current form and are a critical reason for the increasing prevalence of class actions in Australia. They should be replaced with a more appropriate standard that provides a due diligence defence.

Section 674(2) Continuous disclosure obligations

Section 674(2) puts primary liability on an ASX-listed entity for failing to comply with continuous disclosure laws. Essentially, if a company omits to release material information on time, it is liable under section 674(2).

Until the Treasurer's temporary change to the law, there was no defence available for ASX-listed entities under section 674(2). It was essentially strict liability – if a company failed to disclose information that is 'material' and a 'reasonable person' would have disclosed the information, then ASIC could pursue the company and class action litigants could seek compensation.

On 26 May, the Treasurer used his COVID-19 emergency regulation-making powers to issue a determination to temporarily modify the continuous disclosure provisions. The determination modifies the operation of the civil penalty provisions, for proceedings brought by either ASIC or private litigants, by establishing a temporary test that requires the plaintiff to show knowledge, recklessness or negligence with respect to whether information was material for the purposes of the ASX Listing Rules.

The changes recognise the difficulty in knowing "whether a given piece of information will have a material effect on the price or value of its securities". It is designed to encourage ongoing information disclosure as well as the continuation of business operations. It recognises that liability should not arise without proof of a fault-based element, namely, knowledge, recklessness or negligence.

Importantly, the Treasurer's temporary change restores the law to the position that applied before the *Financial Services Reform Act* of 2001 and which had served financial markets well. Before that time, it was a breach of the Act for an ASX-listed entity to *intentionally, recklessly or negligently* contravene the continuous disclosure rules.[9] This test imposed a fault element for continuous disclosure contraventions.

[9] Former Corporations Act section 1001A.

This fault element was removed in what was purportedly a 'housekeeping' change to the Corporations Act. That housekeeping change was not mentioned at the time by the Joint Parliamentary Committee on Corporations and Securities, the Department of the Parliamentary Library, or by any of the Members who spoke during parliamentary debate on the Bill. Nor was it referred to in the Explanatory Memorandum to the Bill.[10] The housekeeping change has had unfortunate unintended consequences, creating in substance strict liability for continuous disclosure breaches under section 674(2) and a clear pathway for class action litigants to pursue ASX-listed entities.

The Treasurer's temporary change to the Act has created a 'defence' for ASX-listed entities under section 674(2) that is broadly similar to the defence applying to section 674(2A). Section 674(2A) imposes liability on "persons involved" in an ASX-listed entity's contravention, also referred to as "accessorial liability". "Persons involved" could include the Directors or Executives who failed to disclose information. Civil penalties apply, so ASIC can sue the persons involved.

Under section 674(2B) there has been and remains a limited due diligence defence that applies if the person took all steps that were reasonable in the circumstances to ensure that the ASX-listed entity complied with its continuous disclosure obligations under section 674(2) and, after doing so, the person believed on reasonable grounds that the listed entity was complying with its obligations under the section.

However, the defence to accessorial liability for "persons involved" under section 674(2B) did not protect the ASX-listed entity itself, leaving the ASX-listed entity without a defence. The Treasurer's temporary changes address this inconsistency so that ASX-listed entities cannot be pursued under section 674(2) without proof of a fault element, and, in our view, this should be retained on a permanent basis – whether in its current form or as a due diligence defence for ASX-listed entities. As it currently stands, the Treasurer's determination is automatically repealed at the end of six months (26 November).

Section 1041H Misleading or deceptive conduct

A further area of concern currently left unaddressed are the misleading or deceptive conduct provisions under section 1041H (civil liability only) and related provisions (e.g. sections 769C, 1041E and 1041F of the Corporations Act and sections 12BB(1) and 12DA of the ASIC Act).

Under 1041H the ASX-listed entity is essentially strictly liable for any error in a release made on the ASX, including inadvertent errors. The issue here is not a failure to disclose; rather, it's about an error in the disclosure. There is no defence under 1041H and no requirement for proof of knowledge, recklessness or negligence as to the misleading nature of a statement.

We contend there should be a limited due diligence defence that allows listed entities to defend claims under section 1041H where they took reasonable steps to ensure the entity's compliance and believed on reasonable grounds it had complied [or, alternatively, there should be a requirement for ASIC or a litigant to prove a fault element so that liability only arises where the ASX-listed entity has knowledge of, or is reckless or negligent as to, the misleading nature of a statement].

[10] ALRC Report 134 *Integrity, Fairness and Efficiency—An Inquiry into Class Action Proceedings and Third-Party Litigation Funders* at paragraph [9.17], page 262 https://www.alrc.gov.au/wp-content/uploads/2019/08/alrc_report_134_webaccess_2.pdf.

Additionally, the related strict liability provisions in the Act (e.g. sections 769C, 1041E and 1041F of the Corporations Act and sections 12BB(1) and 12DA of the ASIC Act) should also be subject to the same considerations set out above to ensure a consistent approach to liability.

Section 180 and 'stepping stones' claims – Anomalous outcomes to sections 674(2A) and (2B)

Currently, company directors and officers face what is, in substance, strict 'stepping stones' liability for causing or permitting their ASX-listed company to contravene the continuous disclosure regime in section 674(2) (or related provisions of the Act outlined above).

This is an anomalous rule because, as noted above, the continuous disclosure regime (section 674(2A)) already imposes specific liability on directors, officers and other persons involved in the ASX-listed entity breaching continuous disclosure rules, subject to a 'reasonable steps' defence under section 674(2B). In contrast, the general duty of reasonable care in section 180 of the Act – which applies to directors and officers – does not contain an equivalent 'reasonable steps' defence.[11]

The anomaly has materialised in recent cases where directors and officers have been found not to have breached section 674(2A) of the Act (to which the defence in section 674(2B) applies), but were nonetheless found liable for breaching section 180 (to which no equivalent 'reasonable steps' defence applies) for exactly the same conduct.[12]

This anomaly should be addressed by providing for an equivalent 'reasonable steps' defence for directors and officers under section 180. Such 'reasonable steps' defence could be included in section 180 either through a new provision that is equivalent to 'reasonable steps' defence in section 674(2B) or through aligning the scope of the business judgment rule defence in section 180(3) with section 674(2B).

Enforcement

Consideration should be given to whether enforcement under section 674(2) and section 1041H (and related sections of the law that impose strict liability) should be limited to ASIC for certain forms of conduct. If the aim of these sections is to deter bad conduct then it could be argued the appropriate plaintiff should be ASIC, acting in the public interest, and not a class action litigant.

If the Treasurer's temporary fault-based elements are to be retained under 674(2) (and there is a limited due diligence defence that allows listed entities to defend claims under section 1041H of the Corporations Act (and related sections of the law that impose strict liability)), one option may be for enforcement under those provisions to be limited to ASIC where the basis of the claim is the ASX-listed entity's negligence (and not knowledge or recklessness). This change would still allow class action plaintiffs to pursue an action against an ASX-listed entity where the contravening conduct involves knowledge or recklessness. However, granting ASIC the exclusive right to enforce sections 674(2) and 1041H (and related sections

[11] The business judgment rule defence in section 180(3) of the Act only applies to decisions in respect of 'business operations' of a company and courts have held that decisions in respect of continuous disclosure. are not decisions in respect of such 'business operations': *Australian Securities and Investments Commission v Vocation Limited (in liquidation)* [2019] FCA 807.

[12] E.g. *Australian Securities and Investments Commission v Vocation Limited (in liquidation)* [2019] FCA 807.

of the law that impose strict liability) where only negligence is alleged will ensure these actions are pursued in the public interest rather than commercial interest.

Litigation funder model and damages

Shareholder class actions have been largely underwritten by litigation funders which have earnt large sums from settlements and court ordered payouts which is generating significant internal rates of return. Importantly, the higher returns to the funders are drawn from money that would otherwise go to the members of the class for whom they act. The higher the rate of return for the funders, the lower the level of compensation to the actual plaintiffs.

Litigation funders have a role to play in Australia's legal system by coordinating and funding class actions and providing access to justice for individuals who have been harmed by corporate malfeasance.

However, the funders have a strong incentive under the current disclosure laws to target companies for misstatements, as opposed to malfeasance, and in particular to go after the larger companies for more substantial payouts.

The Treasurer recently announced that litigation funders will be required to hold an Australian Financial Services Licence and will be regulated as managed investment schemes. The Business Council supports the use of licensing to increase accountability and transparency for litigation funders, particularly in relation to conduct and disclosure and managing conflicts of interest.

Further steps may be considered. A duty on the court should be considered to appoint a contradictor when considering the fairness of the fee arrangement and split of proceeds. Sixty-one per cent of the compensation awarded for shareholder class actions in Australia in 2019 went to litigation funders and lawyers, with just less than 40 per cent for the plaintiffs.[13]

Currently, the plaintiffs delegate to the lawyer and funder the power to make decisions on settlement terms. However, as observed by Kirk (2018), "such settlements involve the determination of legal rights of group members, who are not generally represented. The courts naturally look to representatives of the applicant for assistance, but the interests of all group members are not necessarily uniform nor the same as those of the applicant. Conflicting interests and duties are rife."[14] A positive duty on the court to appoint a contradictor to argue the case for the plaintiffs and against the funder could help resolve this problem.

An alternative approach could be to set a condition of the AFSL of each funder that in any award or settlement the funder must structure their fee arrangements so that shareholders must receive no less than a certain percentage of the net proceeds (after legal costs). Different percentages could apply depending on the size of the award.

Caps or limits on damages

Drawing on experience in addressing the crisis in availability and affordability of public liability and professional indemnity insurance, imposing caps on the damages to be paid

13. Analysis by Herbert Smith Freehills reported in AFR, Lawyers want a bigger slice of class actions, Jennifer Hewitt, 16 June 2020
14. Jeremy Kirk, "The case for contradictors in approving class action settlements", Australian Law Journal, Volume 92 Part 9, 2018

under shareholder class actions might also be considered. In early to mid-2000s, a range of tort law reforms were implemented by State, Territory and Commonwealth governments to address the drivers of the crisis, including increasing cost of claims. The law reforms fell into three major categories – establishing liability, procedural reforms and damages.

Changes to damages largely related to capping or changing the amount of damages paid to an injured person for personal injury or for a claim for economic loss against a professional. Caps and limits on damages have also been used in compulsory third-party motor vehicle insurance and workers' compensation insurance to put downward pressure on premiums.

The Committee should consider the potential impact of implementing a cap on the upper limit of liability for directors and companies for breach of continuous disclosure obligations and misleading and deceptive conduct.

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