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Shareholder Activism: Consumerism, Class Actions and Litigation Funding

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SUMMARY

Recent years have seen a rapid rise in the number of class actions, particularly securities class actions, directed against Australian companies. This is the result of a combination of disparate factors, including, but not limited to, fundamental shifts in the classical model of the company in Anglo-Australian law, the rise of a pro-consumer mentality in the orientation of the legal system, the advent of litigation funding and changes in Government policy regarding retirement incomes.

This situation has come about so quickly that many companies and their advisers are still coming to grips with its implications.

Every listed company is a potential target for a securities class action, but recent developments, such as the Sons of Gwalia litigation and the award of damages in the Jubilee Mines case, show the particular relevance of this topic for the resources sector.

In this paper, we will plot the development of securities class actions, provide a detailed snapshot of the current state of play and look forward to possible future directions.

INTRODUCTION

The landscape of legal liability facing corporations has changed dramatically over the last five to 10 years and promises to continue to evolve. This paper examines the following developments that have caused that change:

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- the rise of the consumer-investor;
- consumerism's creation of broad statutory causes of actions;
- consumerism's erosion of the doctrine of maintenance of capital;
- the rise of the Australian class action; and
- the availability of litigation funding.

The combination of these factors has meant that corporations, directors and their professional advisers are more likely to face litigation, frequently in the form of the shareholder class action, resulting in new risks to be identified and guarded against.

MAINTENANCE OF CAPITAL

Theory versus Reality

Until relatively recently, the introduction to company law in law schools tended to follow a predictable course. Everything was based on two fundamental concepts: limited liability and the doctrine of maintenance of capital.

Students were taught that a company was a faustian bargain between investors and creditors: as long as the company was a going concern, investors were entitled to be shielded from personal liability for its debts. However, once the company became insolvent, shareholders faded from the scene and their investment was appropriated to pay out the company's creditors. That, of course, was where the doctrine of maintenance of capital came in – the notional concept of a pool of capital that was retained for the benefit of creditors (and which creditors dutifully checked before extending credit to the company).

There was a simple problem with all of this: it bore little relationship to reality, at least by the latter stages of the 20th century (and probably for large parts of the 19th century as well). From the theory of law school, young lawyers found themselves pitched into a strange world where the law insisted on strict compliance with rules about par value and nominal capital and issued capital and authorised capital, but companies and investors dealt in shares which had a real value that bore no relation to their par value and with creditors who had little or no interest in a company's statement of capital.

Goodbye to Par Value

Eventually, something had to give, and it was the law. The first major breakthrough came in 1989, when the States and the Commonwealth decided to amend the Companies Code to allow companies to buy back their own shares.

Anyone who was around at the time will remember that it was a bit of a false dawn, because the checks and balances designed to prevent misuse of buybacks were so complex and onerous that nobody could figure out how to come up with a buyback that satisfied all the rules. Nevertheless, the tide of history was definitely on the turn: the fact that the sky didn't fall in when buybacks were notionally legalised emboldened the legislature, and they soon enacted a more workable set of buyback rules (largely the same as we have today).

The legalisation of buybacks was soon followed by a liberalising of the rules for the reduction of capital and, in symbolic terms, the most significant change – the abolition of par value by the *Company Law Review Act 1998*. Both the Explanatory Memorandum to the Act and the Companies and Securities Law Review Committee report on which it was based recognised that, as a device to protect creditors, par value had outlived its usefulness.

A Monstrous Suggestion

By 2000, therefore, the doctrine of maintenance of capital was effectively dead. However, in the course of its long life it had given birth to some legal offspring, one of which was the rule in *Houldsworth's* case.[1] This rule and its descendants were summed up by Finkelstein J in *Sons of Gwalia Ltd (Subject to Deed of Company Arrangement) v Margaretic*:

> "There the House of Lords laid down the rule that a person who subscribed for shares cannot recover damages from the company in an action in deceit for the misrepresentation which induced him to take the shares. His remedy is to rescind the allotment and obtain restitution of his subscription money. There are two explanations for the decision. The first is that to permit recovery by the shareholder would be inconsistent with his statutory contract with the company and the other shareholders under which his subscription money is to be applied towards the discharge of the company's debts. The second explanation is that the share capital of the company is a fund that is available for creditors and therefore claims by a member must be subordinated to those of creditors.
>
> The rule applies whether or not the company is in liquidation. In other words, a member who has not rescinded the allotment cannot while the company is a going concern bring an action in damages against the company: *In re Addlestone Linoleum Company* (1887) 37 Ch D 191. Nor can he be admitted to proof if the company is being wound up: *Oakes v Turquand* (1867) LR 2 HL 325; *Tennent v City of Glasgow Bank* (1879) 4 App Cas 615. Indeed, as these cases show, once the winding up has commenced the right to rescind, and therefore the right to claim damages, is forever lost: *Webb Distributors (Aust) Pty Ltd v State of Victoria* (1993) 179 CLR 15, 30."[2]

[1] *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317.

[2] *Sons of Gwalia Ltd (Subject to Deed of Company Arrangement) v Margaretic* (2005) 149 FCR 227 at [12].

To fully appreciate the moral force behind this principle, one can do no better than to quote from one of the cases cited by Finkelstein J:

> "it would be monstrous to say that … a shareholder … having held himself out to the world as such, and having so remained … could, by repudiating the shares on the ground that he had been defrauded, make himself no longer liable."[3]

This, it must be remembered, was at a time when England had just outlawed the use of children as human chimney brushes. The use of the term "monstrous", therefore, indicates a moral universe that we would have difficulty identifying with today. Nevertheless, the Lords' mentality (not wholly stripped of its moral overtones) is still reflected in modern Australian company law (as evidenced by Finkelstein J's reference to the High Court decision in *Webb Distributors (Aust) Pty Ltd (Aust) Ltd v Victoria*.[4]

However, things are changing very quickly.

Investors as Consumers

One of the least-remarked changes in Australian corporate culture over the last 20 years has been the rise of the consumer-investor.

This phenomenon can probably be traced back to two key events:

- the Hawke Government's decision to promote private superannuation as a substitute for government-funded old age pensions;
- the wave of demutualisations that began in the late 1980s.

There have been a number of significant flow-on effects from this. One is eagerly catalogued on an annual basis by the Australian Stock Exchange (ASX) – the annual growth in the number of Australians who own shares.[5] The other is the phenomenon of investors who do not really understand the market.

This latter phenomenon is evidenced by the success of David Tweed. However, it has also attracted some judicial attention. In one of the *Tweed*[6] cases, Emmett J pointed out that there are some people who just shouldn't be shareholders:

> "Demutualisation can have the result that persons who became members of a mutual society in order to take advantage of the benefits provided by such membership are converted into shareholders of a company limited by shares. Such persons may be quite unfamiliar with the concept of holding shares in a limited company and may be quite unsuited as the recipients of shares that are freely alienable. …

[3] *Oakes v Turquand* (1867) LR 2 HL 325.

[4] (1993) 179 CLR 15.

[5] For the record, the latest figures show that 44% of the population owns shares directly and 55% indirectly or directly: *Australia's Share Owners: An ASX Survey of Share Investors in 2004*, ASX, 2005.

[6] *Aevum Ltd v National Exchange Pty Ltd* [2004] FCA 178.

> The shares that are issued in a demutualisation process represent a distribution of wealth to the members of the mutual association, which the members would otherwise not have the opportunity of acquiring. However, it would be unfortunate if that wealth were to be lost to members of Aevum, as a result of the members being importuned by organisations such as National Exchange, simply because they have received property with which they are unfamiliar and with respect to which they have no experience."[7]

In the light of these factors, it is perhaps no surprise that one of the main protections for investors in the *Corporations Act* is the misleading or deceptive conduct provisions. This is all a long way from the 19th century view of a shareholder, and the idea that it would be monstrous for a shareholder to complain about having been defrauded.

SECURITIES LAW CAUSES OF ACTION

Statutory Framework

The Australian securities law causes of action may be divided into general and specific prohibitions on misleading and deceptive conduct or statements. The misleading and deceptive formulation comes from the consumer protection context of the *Trade Practices Act 1974* (Cth) (TPA) which through judicial decisions was extended to securities until securities specific legislation was enacted in 1998.[8] The TPA ceased to apply to financial services after 1 July 1998 when the *Australian Securities and Investments Commission Act 2001* (Cth) (ASIC Act), s 12DA and other provisions mirroring the TPA were enacted.[9] However, the extensive case law on s 52 remains applicable.[10]

The legislative regime for securities is now embodied in the *Corporations Act 2001* (Cth) and ASIC Act. The scope of the general provisions is very broad and covers conduct in relation to a financial product or financial service. However, conduct that contravenes a specific provision against misleading and deceptive statements, *Corporations Act 2001* (Cth), s 670A (takeover documents) and s 728 (fundraising document), is excluded from the general provisions.[11]

7 *Aevum Ltd v National Exchange Pty Ltd* [2004] FCA 178 at [109].

8 For example, *Poseidon Ltd v Adelaide Petroleum NL* (1991) 105 ALR 25 (representations made during the course of a takeover) and *Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452 (prospectus).

9 TPA, s 51AF(2)(a). Similar amendments were included in State Fair Trading Acts to achieve the same result.

10 See *National Exchange Pty Ltd v ASIC* (2004) 49 ACSR 369 at [18].

11 *Corporations Act 2001* (Cth), s 1041H(3) and ASIC Act, s 12DA (1A).

Financial Products and Financial Services

The *Corporations Act 2001* (Cth), s 1041H and the ASIC Act, s 12DA provide broad ranging causes of action premised on engaging in misleading and deceptive conduct.

Section 1041H(1) of the *Corporations Act 2001* (Cth) provides: "A person must not, in this jurisdiction, engage in conduct, in relation to a financial product or a financial service, that is misleading or deceptive or is likely to mislead or deceive."

"Financial product" is defined in Pt 7.1, Div 3. The definition includes a security, an interest in a registered managed investment scheme, a derivative, various insurance products, superannuation interests, retirement savings accounts, certain deposit-taking facilities and foreign exchange contracts.[12] "Financial service" is defined in Pt 7.1, Div 4. The definition includes providing financial product advice and dealing in a financial product.[13] Engaging in conduct in relation to a financial product also includes issuing a financial product, publishing a notice in relation to a financial product, making or making an evaluation of or recommendation about an offer under a takeover bid.[14]

The ASIC Act, s 12DA provides: "A person must not, in trade or commerce, engage in conduct in relation to financial services that is misleading or deceptive or is likely to mislead or deceive."

Although s 12DA is in similar terms to s 1041H it only relates to "financial services", which is defined so as to have a different scope to the definition in the *Corporations Act* Pt 7.1, Div 4.[15]

The *Corporations Act 2001* (Cth), s 1041I and ASIC Act, s 12GF(1), provide that a person who suffers loss or damage by conduct in contravention of s 1041H or s 12DA respectively, may recover the amount of loss or damage by action against the person contravening the section or against any person involved in the contravention.

Fundraising/Prospectus

Chapter 6D of the *Corporations Act 2001* (Cth) deals with when a disclosure document[16] is required to raise funds and the content, procedure, liability and defences associated with those documents.

[12] See *Corporations Act 2001* (Cth), s 764A(1) and P S B Hutley and P A Russell, *An Introduction to the Financial Services Reform Act 2001* (3d ed), 2005, at [1.14]-[1.30].

[13] See *Corporations Act 2001* (Cth), ss 766A, 766B and 766C and P S B Hutley and P A Russell, *An Introduction to the Financial Services Reform Act 2001* (3d ed), 2005, at [1.31]-[1.39].

[14] *Corporations Act 2001* (Cth), s 1041H(2).

[15] ASIC Act 2001 (Cth), s 12BAB.

[16] Disclosure documents includes prospectuses, short form prospectuses, "transaction specific" prospectuses, profile statements and offer information statements. See *Corporations Act 2001* (Cth), Pt 6D.2, Div 3.

The *Corporations Act 2001* (Cth), s 728 (1), provides that a person is prohibited from offering securities under a disclosure document where there is a misleading or deceptive statement in the disclosure document, any application form accompanying the disclosure document, or any document that contains the offer if the offer is not in the disclosure document or the application form.

The *Corporations Act 2001* (Cth), s 729, provides a right of compensation in similar terms to *Corporations Act 2001* (Cth), s 1041I, that is, a person who suffers loss or damage because an offer of securities under a disclosure document contravenes s 728(1) may recover the amount of the loss or damage from a list of specified persons (for example, person making the offer, directors, proposed directors, underwriters, persons making statements in the disclosure statement and a person who contravenes, or is involved in the contravention of, s 728(1)).[17] However, unlike s 1041H, a number of defences are available. These include reasonable reliance on information given by some one else, withdrawal of consent, reasonable inquiries and reasonable belief ie due diligence, and lack of knowledge.[18] A person is not liable under s 729 for a contravention of s 728(1) if the person proves a defence. The statute of limitations period is six years.[19]

Takeovers

Company takeovers in Australia are regulated by Ch 6 and 6A-6C of the *Corporations Act 2001* (Cth). The purpose of Ch 6B is to prohibit misleading or deceptive statements in takeover documents issued under Ch 6, compulsory acquisition and compulsory buy-out notices issued under Ch 6A and experts' reports issued under both chapters.

Section 670A contains a prohibition on giving various takeover documents if there is a misleading or deceptive statement in the document. The documents include the bidder's statement, target's statement, compulsory acquisition and compulsory buy-out notices and experts' reports. Section 670B provides that a person who suffers loss or damage that results from a contravention of s 670A(1) may recover the amount of the loss or damage from a list of specified persons (for example, the bidder, director of a bidder, the target, director of the target, persons making statements in the documents and a person who contravenes, or is involved in the contravention of, s 670A(1)). A number of defences are available, namely, the person did not know that the statement was misleading or deceptive, the person did not know that there was an omission, reasonable reliance on information given by someone else, and withdrawal of consent.[20] A person is not liable under s 670B for a contravention of s 670A(1) if the person proves the defence. The statute of limitations period is six years.[21]

[17] *Corporations Act 2001* (Cth), s 729(1).
[18] *Corporations Act 2001* (Cth), ss 731, 732 and 733.
[19] *Corporations Act 2001* (Cth), s 729(3).
[20] *Corporations Act 2001* (Cth), s 670D.
[21] *Corporations Act 2001* (Cth), s 670B(2).

Continuous Disclosure

The ASX Listing Rules contain several provisions which require listed bodies to make immediate disclosure of information to the market. The main provisions are as follows:

> "3.1 Once an entity is or 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, the entity must immediately tell ASX that information.
>
> 3.1A Listing rule 3.1 does not apply to particular information while all of the following are satisfied.
>
> 3.1A.1 A reasonable person would not expect the information to be disclosed.
>
> 3.1A.2 The information is confidential and ASX has not formed the view that the information has ceased to be confidential.
>
> 3.1A.3 One or more of the following applies.
> - It would be a breach of a law to disclose the information.
> - The information concerns an incomplete proposal or negotiation.
> - The information comprises matters of supposition or is insufficiently definite to warrant disclosure.
> - The information is generated for the internal management purposes of the entity.
> - The information is a trade secret."

The *Corporations Act 2001* (Cth), Ch 6CA, gives the ASX Listing Rules legislative backing by requiring listed disclosing entities to notify the ASX of information required to be disclosed by Listing Rule 3.1 where that information is not generally available and is information that a reasonable person would expect, if it were generally available, to have a material effect on the price or value of ED securities of the entity.[22] The entity and any person involved in the entity's contravention may be held liable.[23] Although a due diligence offence is available for individuals.[24]

The continuous disclosure regime, as it existed under the *Corporations Law*, has recently been considered in *Riley v Jubilee Mines NL*.[25] Jubilee was a small West Australian gold explorer. In 1994 it received a letter from Western Mining Corporation (WMC), informing it that WMC had accidentally done some drilling on one of Jubilee's tenements.[26] The letter included the results of the drilling,

[22] *Corporations Act 2001* (Cth), s 674, deals with listed disclosing entities and s 675 deals with other disclosing entities. When information is generally available is defined in s 676 and the material effect on price or value is defined in s 677.

[23] *Corporations Act 2001* (Cth), ss 674(2A) and 675(2A).

[24] *Corporations Act 2001* (Cth), ss 674(2B) and 675(2B).

[25] [2006] WASC 199.

[26] The court speculated on whether WMC had sent the letter in its capacity of good corporate citizen or whether because "WMC did not want a repeat of the events surrounding Ernest Henry". See *Riley v Jubilee Mines NL* [2006] WASC 199 at [69].

which showed the presence of nickel. Jubilee effectively filed the letter away and went on looking for gold.

In 1996, WMC began talks with Jubilee about a possible joint venture in relation to the nickel in the tenement. Jubilee then announced the 1994 drilling results to the market. Jubilee's share price subsequently rose.

A shareholder sued Jubilee for damages. The shareholder had sold a large number of Jubilee shares between 1994 and 1996. His argument was that he would have held back and sold at a later time if the nickel drilling results had been announced to the market on 1994.

The Supreme Court of Western Australia held that the nickel results from WMC's drilling had been materially price-sensitive information back in 1994. In accordance with the continuous disclosure requirements of ASX and the *Corporations Act 2001* (Cth), therefore, the results should have been disclosed to the market at that time. The court awarded the shareholder damages of $1.856 million.

When determining whether the nickel results had been materially price-sensitive, the court had regard to the type of company involved and the type of people who usually trade in the shares of that type of company:

> "[I]t is not relevant to ask what a member of the general public might make of the information. Nor is it relevant to consider the information from the point of view of a stockbroker or a geologist or a mining entrepreneur. What is to be considered is the perspective of the person who 'commonly', as opposed to occasionally or rarely, invests in securities. There are, of course, persons who commonly invest in securities but would not dream of investing in speculative mining stocks. Presumably such persons would never be in a position of deciding whether to buy or sell such shares. They simply do not trade in that area. So the notional person to be considered in this case is a person who commonly invests in small speculative miners."[27]

Applying that test, the court held that investors in small speculative miners (like Jubilee) would have made investment decisions on the basis of the nickel results. In arriving at that conclusion, the court dismissed two arguments by Jubilee.

First, Jubilee argued that the nickel results would not have affected its share price in 1994 because it was then just a gold miner. The court's response, in essence, was that a junior explorer is a junior explorer first, and a gold or nickel miner second: "there is no reason why, if, in the course of exploration activities it comes across an interesting result for nickel when it is looking for gold, it cannot then go off and look for nickel."[28]

Second, Jubilee also argued that, if it had announced the results in 1994, it would have included a statement that it didn't intend to follow up on the nickel results. The court rejected the fundamental premise of this argument: "It is simply not the practice of junior explorers to include negative sentiments when

[27] *Riley v Jubilee Mines NL* [2006] WASC 199 at [63].
[28] *Riley v Jubilee Mines NL* [2006] WASC 199 at [174].

announcing positive results. … That is just not the way that junior explorers operate."[29]

Immediately after this decision was handed down (on 6 September 2006) Jubilee said that it was examining the possibility of an appeal. However, there has been no subsequent statement on this issue from the company.

Under the *Corporations Act 2001* (Cth) contravention of the above provisions may directly ground a claim for damages. The substantive subsections are civil penalty provisions for which a court must make a declaration of contravention if satisfied that a contravention has occurred.[30] Any person who suffers damage in relation to a contravention of a financial services civil penalty provision may apply for a compensation order.[31] A court may order a person (the liable person) to compensate another person (including a corporation) for damage suffered by the person if (a) the liable person has contravened a financial services civil penalty provision and (b) the damage resulted from the contravention.[32] Proceedings for a compensation order may be started no later than six years after the contravention.[33]

Alternatively proceedings may be commenced against a person/body corporate to enforce compliance with the ASX Listing Rules by ASX, the Australian Securities and Investment Commission (ASIC) or a person aggrieved by the failure, which is defined to include shareholders of the body corporate.[34]

In addition, disclosures that are inaccurate or a failure to disclose when obligated to provides key evidence of misleading and deceptive conduct for the purposes of *Corporations Act 2001* (Cth), s 1041H, and ASIC Act, s 12DA.

CONSUMERISM AND MAINTENANCE OF CAPITAL

Re Media World Communications Ltd

Media World Communications[35] (MWC) was formerly Werrie Gold Ltd. It became a technology company in 2001.

MWC raised money under a prospectus in 2004 to develop video compression technology. A few months later, doubts were raised about the technology. The share price slumped and the company subsequently went into voluntary administration.

[29] *Riley v Jubilee Mines NL* [2006] WASC 199 at [294].
[30] *Corporations Act 2001* (Cth), s 1317E.
[31] *Corporations Act 2001* (Cth), s 1317J(3A).
[32] *Corporations Act 2001* (Cth), s 1317HA(1).
[33] *Corporations Act 2001* (Cth), s 1317K. See also *Corporations Act 2001* (Cth), s 1314, which creates a continuing obligation to comply until the disclosure is made.
[34] *Corporations Act 2001* (Cth), s 793C. See also *Corporations Act 2001* (Cth), s 1101B.
[35] (2005) 52 ACSR 346.

A group of shareholders who had acquired shares off the prospectus claimed to have done so on the basis of misleading conduct or misleading material in the prospectus. They indicated to the administrator that they intended to prove as creditors in the administration for the loss in the value of their shares.

The administrator applied for directions as to whether those shareholders were entitled to be treated as creditors. If the answer were affirmative, he intended to admit their claims. This would them allow them to vote on a Deed of Company Arrangement (DOCA) and, if the DOCA so provided, to have their claims dealt with under the DOCA.

It had previously been held that "creditor" in relation to voluntary administration has the same meaning as in relation to winding up – a person who has a debt or claim against the company which is present or future, certain or contingent, ascertained or sounding only in damages as provided by s 553(1) of the *Corporations Act 2001* (Cth)

Finkelstein J noted that, in a winding up, s 563A of the *Corporations Act 2001* (Cth) postpones the claims of shareholders to the claims of other unsecured creditors, but he did not believe that s 563A was imported into voluntary administration.

In any event, the question of whether the shareholder in this case was a creditor was, in effect, "short-circuited" in *Houldsworth's case*: a person who has subscribed for shares in a company cannot recover damages on a claim that he subscribed on the basis of misrepresentation.[36] Instead, his remedy is to rescind his subscription and obtain restitution of his subscription money.[37]

If a company is being wound up or in voluntary administration, a shareholder cannot renounce his shares (although, in the case of voluntary administration, the court can allow rescission of the share subscription contract: s 437F). It followed, therefore, that the claimant shareholders in this case were barred by the rule in *Houldsworth's*.

Cadence Asset Management Pty Ltd v Concept Sports

Concept Sports[38] listed on 10 June 2004 after an IPO with an issue price of 50c. On 18 August 2004, the company announced that it would not meet the revenue or profit figures in its prospectus. In September, Cadence disposed of its Concepts Sports shareholding for a price of 11.5c per share.

Cadence then began a class action against Concept Sports, alleging that the prospectus had breached s 728 of the *Corporations Act 2001* (Cth). Cadence claimed damages under s 729, which allows a person who has suffered loss from a defective prospectus to recover damages from a number of persons, including the company that issued the prospectus.

[36] *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317 at [325] per Earl Cairns LC.
[37] *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317 at [329] per Selbourne LJ.
[38] (2005) 147 FCR 434.

At first instance, Finkelstein J held that the rule in *Houldsworth's* case applied to actions under s 729. Accordingly, he held that, because Cadence had on-sold its shares, it could not now rescind the subscription contract and so was barred from proceeding with its s 729 claim.[39]

This decision was reversed on appeal.[40] The Full Court noted that the High Court had followed *Houldsworth's* case in *Webb Distributors v Victoria*.[41] That case had concerned a claim for damages allegedly arising from misleading or deceptive conduct in a prospectus. The company itself was in liquidation at the time of the claim. The High Court had also held that s 563A of the *Corporations Act 2001* (Cth) postponed a shareholder's claim for misleading conduct to the claims of other unsecured creditors.

However, the Full Court also looked at the wider policy issues behind *Houldsworth*. In essence, that policy is based on the doctrine of maintenance of capital. To allow a shareholder to rescind his share contract and claim against the company for the purchase price after the company is in liquidation would give the shareholder two bites of the cherry. While the company was a going concern, the shareholder would be entitled to participate in its profits. In return for that right, the shareholder had to pledge a certain amount of capital to the company in the event of its liquidation. If the shareholder could renounce his shareholding after the company had gone into liquidation, the shareholder would be defeating the expectations of creditors for whose benefit the shareholder had originally agreed to subscribe his capital.

The Full Court said that the rule had subsequently been given statutory recognition and modification in s 563A of the *Corporations Act 2001* (Cth). That provision says that payment of a debt by a company in liquidation "to a person in the person's capacity as a member of the company" is postponed to all debts owed to persons "otherwise than as members". The Full Court said that this modified *Houldsworth* by entitling a subscribing shareholder to an indirect return of capital by way of a claim against the company in respect of the initial subscription. However, it also "enshrined" *Houldsworth* by preventing members' claims from derogating from the interests of unsecured creditors.[42]

The Full Court concluded, contra Finkelstein J, that s 729 of the *Corporations Act 2001* (Cth) was not subject to *Houldsworth*:

- there was no textual or other evidence that the legislature had intended subscribing shareholders' rights under s 729 to be subject to the rule in *Houldsworth*; and
- in any event, the mischief to which *Houldsworth* was directed had been addressed by s 563A of the *Corporations Act 2001* (Cth), so that there was no need for the legislature to have intended that s 729 was qualified by *Houldsworth*.[43]

[39] See *Cadence Asset Management Pty Ltd v Concept Sports* (2006) 56 ACSR 309.
[40] *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 147 FCR 434.
[41] (1993) 179 CLR 15.
[42] *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 147 FCR 434 at [43].
[43] *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 147 FCR 434 at [46].

In obiter, the Full Court said that: "However, by reason of s 563A of the Act, if the company is in liquidation the subscriber's right to be paid the loss is postponed until the claims of persons made otherwise than as members have been satisfied."[44]

Johnston v McGrath

In *Johnston v McGrath*[45] Mr Johnston claimed that he had been induced to buy shares in HIH (on market) after reading press reports of HIH's optimistic public statements in 2000. When the HIH share price collapsed, he allegedly incurred a loss. When HIH subsequently went into liquidation, he lodged a proof of debt for his loss, claiming damages under s 52 of the TPA. The liquidator rejected his proof and he appealed.

The court examined the evidence and concluded that Mr Johnston had not relied upon the media reports before buying his shares. It held that he therefore had no claim under the TPA.

Notwithstanding this conclusion, the court then went on to consider, in obiter, what the effect would have been if Mr Johnston had made out his claim under s 52. It reached a number of interesting conclusions.

It noted the decision of the House of Lords, in *Soden v British & Commonwealth Holdings plc*.[46] The Law Lords held that the English equivalent of s 563A of the *Corporations Act 2001* (Cth) did not require the postponement of a misrepresentation claim by a shareholder who had acquired his shares from another shareholder. The New South Wales court said that, if it had had a free hand, it would have followed *Soden*. However, the New South Wales court was bound to follow *Webb Distributors v Victoria*.[47]

The next question examined by the NSW Court was the difference (if any) between the position of a shareholder who bought on market and a shareholder who subscribed on a prospectus. A few months earlier, a single judge of the Federal Court had held that, in *Webb Distributors v Victoria*,[48] the High Court had only ruled on the application of s 563A to a shareholder who had subscribed on a prospectus.[49]

The New South Wales court did not agree with this interpretation of *Webb Distributors*. On both a reading of *Webb Distributors* and the underlying policy objectives, it could see no reason for reading the High Court's decision as limited to a subscriber shareholder.[50]

[44] *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 147 FCR 434 at [49].
[45] (2005) 195 FLR 101.
[46] [1998] AC 298.
[47] (1993) 179 CLR 15.
[48] (1993) 179 CLR 15.
[49] *Sons of Gwalia Ltd (Subject to Deed of Company Arrangement) v Margaretic* [2005] FCA 1305 per Emmett J.
[50] *Johnston v McGrath* (2005) 195 FLR 101 at [77].

Sons of Gwalia Ltd v Margaretic

Sons of Gwalia (SoG)[51] was a miner which was in voluntary administration. Mr Margaretic bought shares in SoG on market in August 2000. A day after his name was entered on the register of members, voluntary administrators were appointed to SoG. SoG reportedly has $862 million-worth of unsecured creditors, including United States noteholders allegedly owed $284 million.[52]

Mr Margaretic claimed that SoG had failed to disclose its financial problems to ASX, as required by the continuous disclosure rules. He asserted an entitlement to damages.

When the administrators proposed a DOCA to SoG's creditors, Mr Margaretic asserted an entitlement to be treated as a creditor. The more crucial issue, however, was the terms of the DOCA itself. It proposed to embody the terms of s 563A of the *Corporations Act 2001* (Cth). If the deed were approved, the result would be that Mr Margaretic's claim for damages would be postponed to the claims of other unsecured creditors.

Mr Margaretic and the administrators went to the Federal Court. The central issue for the court was whether an on-market purchaser of shares was postponed by s 563A.

At both first instance and on appeal, the Federal Court distinguished *Webb Distributors*. It held that s 563A only applies to the claims of a shareholder who subscribes on a prospectus.[53] A shareholder who claims damages for an on-market purchase can rank equally with other creditors in respect of that claim.

The administrators then successfully applied for special leave to appeal to the High Court. That appeal was heard on an expedited basis on 7 August this year.[54]

Soden v British & Commonwealth Holdings plc

Soden[55] concerned a creditors' scheme of arrangement under the English equivalent of s 411 of the *Corporations Act 2001* (Cth). The House of Lords held that the principle is not "members come last": a member having a cause of action independent of the statutory contract is in no worse a position than any other creditor.[56]

In 1988 British and Commonwealth Holdings plc (B&C) took over Atlantic Computers plc. Both B&C and Atlantic subsequently collapsed. A scheme of

[51] (2005) 149 FCR 227.
[52] Elizabeth Sexton, "Riff-raff slip into the creditors' queue", *Sydney Morning Herald*, 20 March 2006.
[53] *Sons of Gwalia Ltd v Margaretic* (2005) 149 FCR 227 at [51], [61] and [131].
[54] *Sons of Gwalia Ltd v Margaretic & Anor; ING Investment Management LLC v Margaretic & Anor* (2006) HCA Trans 430.
[55] [1998] AC 298; [1997] 4 All ER 353.
[56] *Soden v British & Commonwealth Holdings plc* [1997] 4 All ER 353 at 358.

arrangement was proposed for Atlantic. Under the terms of the scheme, the scheme assets were to be distributed pari passu between the scheme creditors broadly on the same basis as if the company were in liquidation.

B&C began an action against Atlantic, claiming that it had been induced to acquire Atlantic by false or misleading representations made by Atlantic as to Atlantic's value, when in reality it was worth far less than B&C had paid for it.

Paragraph 74(2)(f) of the *Insolvency Act 1986* (UK) is similar to s 563A of the *Corporations Act* (Cth). Section 74 says:

> "(1) When a company is wound up, every present and past member is liable to contribute to its assets to any amount sufficient for payment of its debts and liabilities, and the expenses of the winding up, and for the adjustment of the rights of the contributories among themselves.
>
> (2) This is subject as follows …
>
> (f) a sum due to any member of the company (in his character of a member) by way of dividends, profits or otherwise is not deemed to be a debt of the company, payable to that member in a case of competition between himself and any other creditor not a member of the company, but any such sum may be taken into account for the purpose of the final adjustment of the rights of the contributories among themselves …".

The issue for the House of Lords was whether s 74(2)(f) of the *Insolvency Act 1986* (UK), which would apply to the scheme, would have the effect of postponing B&C's claim to those of other creditors.

The House of Lords held that s 74(2)(f) of the *Insolvency Act 1986* (UK) did not apply to a shareholder's claim for negligent misrepresentation against a company where the shareholder-claimant had bought the relevant shares from other shareholders.[57]

After *Soden's* case, the *Companies Act 1985* (UK) was amended to overcome *Houldsworth's* case (and, presumably, modify the operation of s 74(2)(f)). A new s 111A was inserted:

> "A person is not debarred from obtaining damages or other compensation from a company by reason only of his holding or having held shares in the company or any right to apply or subscribe for shares or to be included in the company's register in respect of shares."

[57] *Soden v British & Commonwealth Holdings plc* [1997] 4 All ER 353 at 359-360.

Current State of the Law

	Company solvent	**Company in external administration**
Shareholder subscribes on a prospectus	Shareholder can claim damages from company under s 729 without renouncing shareholding: *Concept Sports*.	Shareholder can claim in winding up, but claim postponed by s 563A: *Sons of Gwalia*, *Concept Sports*.
Shareholder buys shares from another shareholder	*Houldsworth* inapplicable, because renunciation of share subscription is not possible.	Shareholder can claim in winding up, and claim is not postponed by s 563A: *Sons of Gwalia, Concept Sports*. Shareholder can claim in winding up, but claim postponed by s 563A: *Johnston v McGrath*

What are the outstanding issues?

There are four major questions currently surrounding securities class actions in Australia:

1. What will the High Court decide in *Sons of Gwalia*?
2. What did the High Court really mean in *Webb Distributors*?
3. What happened in England after *Soden*?
4. What will happen after the High Court hands down its decision in *Sons of Gwalia*?

What will the High Court decide in Sons of Gwalia?

It would be a brave person who was prepared to predict what the High Court would ever decide!

Nevertheless, when the decision is finally announced, practitioners may well read that the High Court has both upheld the equal status of shareholders and has indicated a willingness to depart from the reasoning in *Webb Distributors*.

What did the High Court really mean in Webb Distributors?

The High Court's judgment in *Webb Distributors* is notoriously difficult to decipher. There is even debate about what the facts of the case were.

The transcripts of the High Court appeal hearing in *Sons of Gwalia* show that *Webb Distributors* was a central issue in the arguments. The administrators argued that Webb Distributors postponed the claims of shareholders who bought on market as well as those who bought on subscription. Mr Margaretic argued that Webb Distributors was confined to shareholders who bought on subscription or, alternatively, that the High Court should revisit Webb Distributors and hold that

s 563A of the *Corporations Act 2001* (Cth) does not postpone the claims of any shareholder who acquired his shares as the result of misleading conduct by the company.

The difficulties of interpreting *Webb Distributors* were acknowledged during the High Court hearings in *Sons of Gwalia* on 7 August 2006 (although the finger of blame was pointed back at the parties in Webb):

> "*Gummow J*: Look, the problem in Webb is, I think, the way the argument was framed for which their Honours then cannot be blamed.
>
> *Hayne J*: It may suggest only that Webb, or a circumstance like Webb, should have been resolved otherwise.
>
> *Gummow J*: Yes.
>
> *Mr Coles*: Yes, Webb should, we can now say, I suppose, without …
>
> *Gummow J*: Out with it, Mr Coles.
>
> *Mr Coles*: It might have been easier for our learned friends and ourselves if Webb had been resolved in the plain straightforward way, for example, that Soden itself was resolved but in the context with which Webb was concerned by first going to 563A or its then equivalent, 360(1)(k) and analysing why the claim in Webb was a claim in the capacity as member."

This issue will hopefully be resolved when the High Court hands down its decision in *Sons of Gwalia*.

Soden's case as a predictor for Australia

It is important to note that, in *Soden's* case, B&C's misrepresentation proceedings against Atlantic were still before the courts at the time of the House of Lords decision. There is no subsequent record of the progress of the claim. It is thus uncertain how the existence of the claim affected the scheme in practice.

Soden's case has not been the subject of subsequent judicial consideration. A review of relevant literature and consultations with English practitioners have not uncovered any indication that *Soden's* case has had an impact on English insolvency practice.

However, it is not clear that this is a good predictor of how the decisions in *Sons of Gwalia* and *Concept Sports* will affect Australian companies.

The first point to note is that *Soden's* case took place almost 10 years ago. At that time, neither litigation funding nor class actions were as developed in the United Kingdom as they currently are in Australia: *Soden's* case involved a single large shareholder, while *Sons of Gwalia* involves a relatively large number of shareholders supported by a litigation funder. This would tend to suggest that the juridical environment in the United Kingdom has not encouraged the type of legal action typified by *Sons of Gwalia*.

The second point is that Australian law has a well-developed body of case law on the concept of misleading or deceptive conduct found in s 52 of the TPA and its

avatars in the *Corporations Act* and the ASIC Act. *Soden's* case involved a claim for negligent misrepresentation. Other available claims in England at that time included deceit, which, like negligent misrepresentation, would have had higher proof thresholds than misleading or deceptive conduct.

Finally, although this does not go to the ultimate resolution of an external administration, it is worth noting that voluntary administration in Australia can, to some extent, be "held hostage" by large numbers of small-claim creditors. If a shareholder were claiming against the company for misleading or deceptive conduct, it would be expected that the normal insolvency administration practice in Australia would be to admit the claim for a nominal amount for voting purposes. A creditor vote in voluntary administration requires a majority of creditors in number and by value. The corresponding situation in England is that voting is only on the value of creditors' claims. Therefore, it would follow that the ability of shareholder creditors to influence a voluntary administration in Australia would be considerably higher than in England.

What will happen after the High Court hands down its decision in Sons of Gwalia?

Whichever side – unsecured creditors or shareholders – wins the appeal in Sons of Gwalia, there are certain to be calls for changes to the law.

To date, most of the noises in this direction have come from the unsecured creditors (for which read "bondholders") lobby. This appears to reflect an unspoken assumption that there is a simply unarguable case to put shareholders after unsecured creditors.

However, it is far from obvious that the Federal Government would automatically step in to restore the status quo ante. Especially in the wake of the Westpoint collapse, the Government may be reluctant to enact measures that would appear to disadvantage retail shareholders. Such a move might be seen as inimical to the current economic policy of encouraging Australians to make greater financial provision for their retirement.

However, the Government could be expected to defuse the situation by referring the issue to the Corporations and Markets Advisory Committee. That would, at the very least, postpone any need to make a decision until well after the next Federal election.

THE RISE OF THE AUSTRALIAN CLASS ACTION

Background

The Australian Law Reform Commission advocated the adoption of an Australian class action procedure in a 1988 report.[58] A class action procedure was

[58] ALRC, *Grouped Proceedings in the Federal Court*, Report No 46 (1988).

adopted in the Federal Court system in 1992, when the Australian Parliament amended the *Federal Court of Australia Act 1976* (Cth) (the FCAA) to introduce what are referred to in that legislation as "representative proceedings".[59]

In the Australian State legal systems Victoria has adopted a class action procedure modelled on the FCAA,[60] the other States continue to rely on outdated Chancery Court procedures. Nonetheless, some form of class action is available in all Australian jurisdictions.

The Australian legal system has seen class actions commenced in a wide range of areas. The first class action that was commenced in Australia under the new rules was one involving financial services. Product liability class actions are common. Australia has seen class actions involving the sale of real property and allegedly defective food, pharmaceuticals, medical devices and other consumer goods. Other actions have involved the marketing of home burglar alarms, financial losses said to have arisen out of the Longford gas explosion and the Sydney Water contamination crisis. Dissatisfied asylum seekers have sued the Minister.

More recently, anti-competitive conduct that has been prosecuted by the Australian Competition and Consumer Commission (ACCC) has also been the subject of class actions from the customers of the businesses that engaged in price-fixing behaviour, and of most relevance for this paper, securities class actions have been commenced in relation to allegedly misleading statements in relation to takeovers, prospectuses and disclosures to the share market.

Federal Court of Australia – the Representative Proceeding Regime

The legislation creating group proceedings in Australia at the federal level is Pt IVA of the FCAA, which was enacted in 1992. Section 33C provides that a proceeding may commence if:

"(a) 7 or more persons have claims against the same person; and
(b) the claims of all those persons are in respect of, or arise out of, the same, similar or related circumstances; and
(c) the claims of all those persons give rise to a substantial common issue of law or fact …."

The "claims against the same person" requirement has been read as meaning that all class members must have a claim against all respondents,[61] but those

[59] *Federal Court of Australia Amendment Act* 1991 (No 181 of 1991).

[60] The only other Australian jurisdiction to enact class action legislation to date is the State of Victoria in Pt 4A of the *Supreme Court Act 1986* (Vic) which mirrors the federal legislation.

[61] *Philip Morris (Aust) Ltd v Nixon* (2000) 170 ALR 487 at 520-521 (Sackville J, with whom Spender and Hill JJ agreed); *King v GIO Australia Holdings Ltd* [2000] FCA 1543 at [3], [10]. However, Finkelstein J (with whom Carr J agreed) in *Bray v F Hoffman-La Roche Ltd* (2003) 130 FCR 317 at [243]-[248] disputed this requirement and argued that the applicants did not need to have claims against all respondents as this would require a proliferation of proceedings. To date lower courts have continued to

claims need not be identical,[62] nor need the claims be ultimately successful against all respondents.[63] The "same, similar or related circumstances" requirement has been interpreted liberally so that some relationship must exist but they certainly need not be identical.[64] Equally, the "substantial common issue of law or fact" requirement is not an onerous one, as "substantial" does not indicate a large or significant issue but instead is "directed to issues which are 'real or of substance'".[65] The idea is that the common issue not be trivial or contrived. The High Court observed that s 33C applies at the commencement of an action when the determination of what issues will be the most significant is difficult. As a result, a lower threshold is justified at this point, because concerns over cases that are allowed to be commenced as representative actions but subsequently become unsuitable are alleviated by s 33N.[66]

The application of the requirements to commence a class action under s 33C in the securities context may be illustrated by the actions involving GIO Holdings Ltd (GIO) and Harris Scarfe Holdings Ltd.

In *King v GIO* the applicant commenced representative proceedings against GIO, an adviser to GIO, Grant Samuel and Associates Pty Ltd and nine directors of GIO in relation to advice given to shareholders of GIO that a takeover offer by AMP Insurance Investment Holdings Pty Ltd (AMP) should not be accepted as it was inadequate. Ultimately, some 68,000 GIO shareholders declined to accept the AMP offer. Subsequently the GIO shares fell as a result of losses in GIO's reinsurance arm. The relief sought in the proceedings included declarations that conduct of GIO contravened s 52 of the TPA. The Federal Court considered the "claims against the same person" requirement and found that the applicant demonstrated that he and each group member had at least one claim which was the same claim against each respondent, namely the application for a declaration that the company, its advisers and its directors had contravened the statutory prohibitions on misleading and deceptive conduct.[67] Further, the substantial issue was the accuracy of the advice given to shareholders, that is whether the valuation of GIO shares and the profit forecast for GIO for the financial year ending 30 June 1999 were inaccurate so that the respondents engaged in misleading and deceptive conduct.[68]

In *Guglielmin v Trescowthick (No 2)* the applicant commenced an action on behalf of shareholders of Harris Scarfe Holdings Ltd (Holdings securities), alleging

follow *Philip Morris (Aust) Ltd v Nixon*. See *Johnstone v HIH Ltd* [2004] FCA 190 at [38] and *Guglielmin v Trescowthick (No 2)* (2005) 220 ALR 515 at [29].

62 *King v GIO Australia Holdings* (2000) 100 FCR 209 at 222-223.

63 *King v GIO Australia Holdings Ltd* [2000] FCA 1543 at [7].

64 *Zhang v Minister for Immigration, Local Government & Ethnic Affairs* (1993) 45 FCR 384 at 404.

65 *Wong v Silkfield Pty Ltd* (1999) 199 CLR 255 at 267.

66 See *Wong v Silkfield Pty Ltd* (1999) 199 CLR 255 at 266 citing *Zhang v Minister for Immigration, Local Government & Ethnic Affairs* (1993) 45 FCR 384 where French J gave judgment on the common issue and then ordered that the proceeding cease to continue as a representative proceeding pursuant to s 33N(1).

67 *King v GIO Australia Holdings Ltd* (2000) 100 FCR 209 at [36], [6] and [7].

68 *King v GIO Australia Holdings Ltd* (2000) 100 FCR 209 at [50]-[51].

that the respondents, who were directors of the said company at various points in time, misrepresented the value of the shares to the group members, through 77 documents including various financial statements, directors statements, annual reports, press releases, prospectus information and other public announcements between the period of 12 March 1996 – 3 April 2001. The respondents sought to have the proceedings dismissed on the basis that not every member of the representative group had a claim against each respondent. The court citing *King v GIO* found that although some claims were made by only some group members against some respondents these were in addition to claims made by all group members against all respondents, namely all held shares as at 3 April 2001 when they allegedly lost the opportunity to sell, so that s 33C(1)(a) was satisfied.[69]

The respondents also sought to have the representative proceeding dismissed on the basis that "the events are alleged to have taken place over five years, the claim group is potentially made up of some 11,300 persons, the different times when these persons bought (and sold) Holdings securities, and the probable differential reliance each may have placed on the various representations in the many published documents pleaded" meant that the claims of all persons did not arise out of "the same, similar or related circumstances".[70] The court refused to dismiss the proceedings on the basis that there were related circumstances arising from the alleged conduct of the respondents in presenting a misleading picture about the financial health of Holdings to the detriment of the holders of its securities at 3 April 2001, the effect of the various communications upon the market perception of the value of Holdings securities compared to the real value of those securities and that the evidence in one claim would very likely be relevant to other claims.[71]

The court also identified a number of substantial common issues: whether the communications in the circumstances are each communications for which the individual respondents may be liable, whether opinions were reasonably held, whether the respondents ought reasonably to have known that the statements were materially misleading, whether the respondents exercised reasonable care to ensure the accuracy of the statements, whether the directors of Holdings owed a duty of care to its shareholders to ensure the accuracy of statements required by the Corporations Law, whether the duty of a director to exercise care and diligence entitled shareholders to recover individual losses for its breach and whether each of the alleged representations (extending between 12 March 1996 and 3 April 2004) was false or misleading or deceptive, or was likely to mislead or deceive.[72]

Under s 33N, the court of its own motion or on application by the respondent may order that the proceeding not continue as a representative proceeding where the costs are excessive as compared to separate proceedings; the relief sought can be obtained without resort to a representative proceeding; the representative

[69] *Guglielmin v Trescowthick (No 2)* (2005) 220 ALR 515 at [35]-[38].
[70] *Guglielmin v Trescowthick (No 2)* (2005) 220 ALR 515 at [45] and [46].
[71] *Guglielmin v Trescowthick (No 2)* (2005) 220 ALR 515 at [51].
[72] *Guglielmin v Trescowthick (No 2)* (2005) 220 ALR 515 at [61]-[68].

proceeding is not an efficient and effective means of dealing with the claims; or it is otherwise inappropriate that the claims be pursued by means of a representative proceeding.[73] Therefore the threshold requirements of s 33C may be easily met, but a court may still use its discretion under s 33N to order the discontinuance of a representative proceeding.[74]

The representative proceedings adopt an opt-out procedure for group members to inform the court that they do not wish to be part of the proceedings.[75] If a group member falling within the defined class does not opt out then they are bound by the outcome of the proceedings.[76] The right to opt out is given effect by the requirement that group members receive notice of that right and of the commencement of the proceedings.[77] This has been interpreted to mean that the notice must inform the recipient of their opt-out right, when the right must be exercised, and the consequences of exercising or not exercising that right.[78] However, the court can order that notice be given by means of press advertisement, radio or television broadcast or by any other means and states that the court may not order that notice be given personally to each group member unless it is satisfied that it is reasonably practicable, and not unduly expensive to do so.[79]

A representative proceeding may not be settled or discontinued without the approval of the court.[80] Further, unless the court is satisfied that it is just to do so, an application for approval of a settlement must not be determined unless notice has been given to group members.[81]

The above discussion demonstrates that the Australian class action makes the aggregation of numerous securities claims easy to accomplish, even when numerous individual issues exist. The infancy of securities class actions means that there has not yet been any trials to test the efficacy of such loose groupings. However, *King v GIO* demonstrates that settlements may be an attractive option so that multiple claims are removed from the judicial system, plaintiffs and plaintiffs'

[73] *Federal Court of Australia Act*, s 33M, also provides for the discontinuance of representative proceedings where, if judgment were to be given in favour of the representative party, the cost to the respondent of identifying the group members and distributing to them the amounts ordered to be paid to them would be excessive having regard to the likely total of those amounts.

[74] *Bright v Femcare Ltd* (2002) 195 ALR 574; [2002] FCAFC 243 at [128].

[75] *Federal Court of Australia Act 1976* (Cth), s 33J, provides for a right to opt out.

[76] *Federal Court of Australia Act*, s 33ZB, requires that a judgment given in a representative proceeding identify the group members affected and binds all such members unless they opted out of the proceeding pursuant to s 33J.

[77] *Federal Court of Australia Act*, s 33X(1)(a), provides for notice of the right to opt out and the giving of a specified date for that right to be exercised by.

[78] *King v GIO Australia Holdings Ltd* [2001] FCA 270 at [15]-[16]; *Courtney v Medtel Pty Ltd* [2001] FCA 1037 at [9].

[79] *Federal Court of Australia Act*, ss 33X and 33Y.

[80] *Federal Court of Australia Act*, s 33V. Section 33W deals with the settlement of a representative party's individual claims. The Act allows for the representative party, with the leave of the court, to settle and withdraw from the litigation provided the court is satisfied that notice of the application has been given to group members.

[81] *Federal Court of Australia Act 1976* (Cth), s 33X(4).

lawyers achieve certainty of recovery and corporations can buy peace. In *King v GIO* a final group of 23,099 claimants received about $2.10 per share, the plaintiffs' lawyers received fees of about $17 million (including a 25 percent uplift of their hourly fee and disbursements) and the company converted a potential liability of $151 million to a settlement of $97 million.[82] Further, the class actions against Concept Sports where shareholders had sought $5 million in damages and Harris Scarfe where $20 million had been sought have now also been recently settled.[83] The settlement in Concept Sports is confidential but the Harris Scarfe settlement was for only $3 million.

State Courts

In States other than Victoria representative proceedings based on the former practices of the Court of Chancery are the primary vehicle for class actions. These proceedings are characterised by a dearth of rules. Typically a proceeding may be commenced if "numerous persons have the same interest" but the factors against a representative proceeding must be aired through requesting the court to use its discretion to prevent the plaintiff from continuing to prosecute the proceedings in a representative capacity. The rules do not address whether or not consent is required from group members; the right of such members to opt out of the proceedings; the position of persons under a disability; alterations to the description of the group; settlement and discontinuance of the proceedings; and the giving of various notices to group members.[84]

For a number of years the fact that the State Supreme Courts had not introduced a class action procedure was of little consequence. As a result of the cross-vesting legislation that had been enacted throughout Australia a person who wished to bring a class action based on common law causes of action could utilise the Federal Court procedure. This changed in 1999 when the High Court of Australia held that key components of the cross-vesting legislation were unconstitutional.[85] Since that time common law causes of action, or those based solely on State and Territory legislation, cannot be pursued in the Federal Court other than in concert with a claim based on a federal cause of action.

As a consequence, lawyers wishing to pursue class actions that lack a federal law component, once again, turned to the old Court of Chancery rules. The High Court also breathed new life into these rules in 1995 when it swept away some of the traditional restrictions that had been applied by the courts over many years.[86]

[82] *King v AG Australia Holdings Pty Ltd* [2003] FCA 980 at [4]-[15].

[83] Marcus Priest, "Concept Sports pays out shareholders", *The Australian Financial Review*, 4 October 2006, p 51 and Matthew Drummond, "Scarfe action settled", *The Australian Financial Review*, 13 October 2006, p 16.

[84] *Esanda Finance Corporation Ltd v Carnie* (1992) 29 NSWLR 382 at 388 and 390 and *Fostif Pty Ltd v Campbells Cash & Carry Pty Ltd* (2005) 63 NSWLR 203 at [278].

[85] See *Re Wakim; Ex parte McNally* (1999) 198 CLR 511.

[86] *Carnie v Esanda Finance Corporation Ltd* (1995) 182 CLR 398.

Notwithstanding the dearth of rules a number of representative actions have been commenced in the Supreme Court of New South Wales. In each case the claims brought by the plaintiffs have not been the 'traditional' subject matter of class actions. Rather, the claims have involved attempts by retailers to recover moneys allegedly paid to their suppliers in relation to state government licence fees which were subsequently held to be unconstitutional. The Chancery Court rules were preferred because they allowed for an opt-in approach that was not available at the Federal level. This particularly appealed to litigation funders (discussed further below) as they were able to ensure that all group members accepted the funding arrangements to be able to participate in the class action.

However in the High Court decision in *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd*, the operation of Pt 8, r 13 of the New South Wales *Supreme Court Rules* was considered and the proposed class action disallowed.[87] The proceedings concerned claims for the recovery of amounts paid by tobacco retailers to tobacco wholesalers, allegedly for the purposes of the wholesalers paying a licence fee, later found to be unconstitutional. As a result, the amounts sought to be recovered in the proceedings were never paid by the wholesalers to the various State and Territory governments. In 2001 the High Court allowed a similar claim by seven New South Wales tobacco retailers against a tobacco wholesaler.[88]

The proceedings were instigated by a litigation funder who was prepared to underwrite the litigation (and meet any costs order against the plaintiffs) in exchange for one-third of any amounts recovered, plus the benefit of any costs order. There were a number of different proceedings, but each took a similar form whereby a single plaintiff retailer made a claim against a defendant wholesaler. However, the summons filed in each proceeding said that the proceeding was brought on behalf of other tobacco retailers who:

- had purchased tobacco products from the defendant wholesaler during the relevant period;
- had not otherwise recovered from the defendant wholesaler any amount referable to licence fees; and
- decided to opt-in to the proceedings by accepting the litigation funder's terms.

The *Supreme Court Rules* 1970, Pt 8, r 13 provided:

> "(1) Where numerous persons have the same interest in any proceedings the proceedings may be commenced, and, unless the Court otherwise orders, continued, by or against any one or more of them as representing all or as representing all except one or more of them."

The introduction of the *Uniform Civil Procedure Rules* in 2005 resulted in Pt 8, r 13 being replaced by r 7.4 which is in similar terms:

> "(1) This rule applies to any matter in which numerous persons have the same interest or same liability in any proceedings.

[87] (2006) 229 ALR 58; 80 ALJR 1441.

[88] *Roxborough v Rothmans of Pall Mall* (2001) 208 CLR 516.

(2) Unless the court orders otherwise, the proceedings may be commenced and carried on by or against any one or more persons as representing any one or more of them."

Part 8, r 13 has been interpreted as being composed of a jurisdictional element, whether there are numerous persons with the same interest in any proceedings so as to allow proceedings to commence, and a discretionary element, whether there are factors which make a representative proceeding undesirable so that a court should otherwise order.[89] The High Court's decision dealt with the jurisdictional element.

The joint judgment of Gummow, Hayne and Brennan JJ observed that "the authority given by Pt 8, r 13(1) to commence representative proceedings depended upon there being, at the time the proceedings were commenced, "numerous persons [having] the same interest' in the proceedings".[90]

A close analysis of the pleading showed that, while Fostif brought its own claim, it made no claim on behalf of any other tobacco retailers. Their participation in the proceedings depended upon them choosing to opt-in to the proceedings. The funder obviously hoped that many retailers would opt-in after the proceedings were instituted but that was only a hope as to future events. Consequently, at the time the summons was issued, there were no persons, other than Fostif, who had an interest in the proceedings. The requirement of "numerous persons" was not satisfied.[91]

The pleading defect was explained through a comparison of *Fostif* with *Carnie v Esanda*.[92] In *Carnie* there were two named plaintiffs who brought proceedings on behalf of all other persons who met certain characteristics giving rise to a group of "represented debtors". *Carnie* did not deal with whether an opt-in or opt-out procedure was to be employed. The *Fostif* pleading employed the same approach as *Carnie*, setting out characteristics that defined the group of "represented retailers", but there was only one named plaintiff and an opt-in procedure was appended. The opt-in procedure meant that Fostif only sought to represent those from within the group who actively chose to be bound. At the time that proceedings were commenced no members of the group had opted-in.[93]

Callinan and Heydon JJ reached the same finding as the joint judgment of Gummow, Hayne and Crennan JJ, but placed more emphasis on the existence of a claim for a declaration in *Carnie* that was not present in *Fostif*, as the declaration affected the rights of all represented debtors.[94]

[89] *Carnie v Esanda Finance Corporation Ltd* (1995) 182 CLR 398 at 405, 415 and 427.

[90] *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 ALR 58; 80 ALJR 1441 at [51].

[91] *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 ALR 58; 80 ALJR 1441 at [56]-[60].

[92] *Carnie v Esanda Finance Corporation Ltd* (1995) 182 CLR 398.

[93] *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 ALR 58; 80 ALJR 1441 at [59]. Compare with [9]-[11] (Gleeson CJ).

[94] *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 ALR 58; 80 ALJR 1441 at [216] and [225].

The High Court decision has created new uncertainty as to how many persons are required to satisfy the requirement of "numerous persons". Further the High Court did not determine whether representative proceedings may be structured as opt-in, opt-out or, as occurred historically, all members of the group were simply bound.[95] The words of Pt 8, r 13, now Uniform Civil Procedure Rules, r 7.4, offer no assistance. As the question was not decided, it may be that any structure is acceptable provided numerosity is established at commencement. The easiest way to do that would be to have a number of known persons as plaintiffs when the proceeding is commenced. The structure of the proceeding would then be considered as part of the discretionary element. It is therefore likely that there will be reform to the Uniform Civil Procedure Rules to create greater certainty. It remains to be seen whether it will be wholesale reform aimed at introducing a modern class action procedure or simply a clearer restatement of the existing wording.

LITIGATION FUNDING LEGITIMISED

Background

Historically improperly encouraging litigation ("maintenance") and funding another person's litigation for profit ("champerty") were torts and/or crimes in all Australian jurisdictions. The common law prohibition of litigation funding was justified in part by a doctrinal concern, namely that the judicial system should not be the site of speculative business ventures. However, the primary aim was to prevent abuses of court process (vexatious or oppressive litigation, elevated damages, suppressed evidence, suborned witnesses) for personal gain. Today, legislation in the Australian Capital Territory, New South Wales, South Australia and Victoria has expressly abolished maintenance and champerty as a crime and as a tort.[96] It seems likely that maintenance and champerty are obsolete as crimes at common law.[97] However, in these jurisdictions, while there is no criminal or civil liability for maintenance and/or champerty, the abolishing legislation does "not affect any rule of law as to the cases in which a contract is to be treated as contrary to public policy or as otherwise illegal".[98]

A litigation funder is a commercial entity that contracts with one or more potential litigants. The funder pays the cost of the litigation and accepts the risk of paying the other party's costs if the case fails. In return, if the case succeeds, the funder is paid a share of the proceeds (usually after reimbursement of costs). The share of the proceeds is as agreed with the client, and is typically between one-

95 *Carnie v Esanda Finance Corporation Ltd* (1996) 38 NSWLR 465 at 469 and 472.

96 *Civil Law (Wrongs) Act 2002* (ACT), s 221; *Maintenance, Champerty and Barratry Abolition Act 1993* (NSW), ss 3, 4, 6; *Criminal Law Consolidation Act 1935* (SA), Sched 11, ss 1(3), 3; *Wrongs Act 1958* (Vic), s 32 and *Crimes Act 1958* (Vic), s 322A.

97 See *Clyne v NSW Bar Association* (1960) 104 CLR 186 at 203 and *Brew v Whitlock* [1967] VR 449 at 450.

98 See eg, *Maintenance, Champerty and Barratry Abolition Act* 1993 (NSW), s 6; *Wrongs Act 1958* (Vic), s 32 (2).

third and two-thirds of the proceeds.[99] Litigation funding has been advocated on access to justice grounds, allowing for the spreading of the risk of complex litigation and improving the efficiency of litigation through introducing commercial considerations that will aim to reduce costs.[100]

Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd

In *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd*, Australia's highest court considered the legality of litigation funding for the first time.[101] The facts of the case are set out above in relation to State court class actions.

The High Court held 5:2 that litigation funding was not an abuse of process or contrary to public policy. The joint judgment of Gummow, Hayne and Brennan JJ explained that in jurisdictions which had abolished maintenance and champerty as crimes and torts, New South Wales, Victoria, South Australia and the Australian Capital Territory, there were no public policy questions beyond those that would be relevant when considering the enforceability of the agreement for maintenance of the proceedings as between the parties to the agreement.[102] In other words, once the legislature abolished the crimes and the torts of maintenance, these concepts cannot be used to found a challenge to proceedings which are being maintained. Their only relevance is in a dispute between plaintiff and funder about the enforceability of the agreement. The court did not decide the position for those States where legislation had not abolished maintenance and champerty as crimes and torts (Western Australia, Queensland, Tasmania and the Northern Territory).

The joint judgment also considered a range of factors specific to the instant litigation, that alone or in combination, were not contrary to public policy or led to an abuse of process.[103] They included:

- the funder's seeking out of claimants, which the appellants described as "officious intermeddling"
- the degree of control which the funder would have over the proceedings, the litigants' interests being said to be "subservient" to those of the funder
- the funder's retainer of a solicitor to act for the plaintiffs and represented parties was said not to lessen the funder's control of the proceedings but to give rise to possible conflicts of duty for the solicitor

[99] Standing Committee of Attorneys-General, *Litigation Funding in Australia* (May 2006), p 4.

[100] *QPSX Ltd v Ericsson Australia Pty Ltd (No 3)* (2005) 219 ALR 1 at [54].

[101] (2006) 229 ALR 58; 80 ALJR 1441. The High Court also considered litigation funding issues in *Mobil Oil Australia Pty Ltd v Trendlen Pty Ltd* (2006) 229 ALR 51; 80 ALJR 1503 which was heard at the same time.

[102] *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 ALR 58; 80 ALJR 1441 at [84]-[86].

[103] *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 ALR 58; 80 ALJR 1441 at [88].

- the funder obtained rights to litigate and did so with a view to profit. The funder was "a speculative investor in other persons' litigation".[104]

The joint judgment opined that fears about a funder conducting themselves in a manner inimical to the due administration of justice could be addressed by existing doctrines of abuse or process and the courts' ability to protect their processes.[105] The joint judgment also rejected the need for special rules to protect against the risk of "blackmail settlements" in class actions as occurred in the United States.[106]

Gleeson CJ and Kirby J agreed with the reasoning of the joint judgment.[107] Callinan and Heydon JJ dissented on this issue.[108]

Regulation Still to Come

Although the High Court has legitimised litigation funding, the shape of the emerging litigation funding industry and its overall effect on litigation will depend to a large extent on whether the various governments choose to regulate the industry and, if so, in what way. The Standing Committee of Attorneys-General (SCAG) is examining the issue of litigation funding which may see legislative change aimed at:

- repealing laws against maintenance and champerty in those jurisdictions where the tort or crime continues to exist;
- specifying criteria for legally acceptable funding agreements; and
- adopting prudential regulation requirements for funders.[109]

[104] *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 ALR 58; 80 ALJR 1441 at [87].

[105] *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 ALR 58; 80 ALJR 1441 at [93].

[106] *CampbellsCash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 ALR 58; 80 ALJR 1441 at [94] citing Friendly, *Federal Jurisdiction: A General View* (1973) at 120, referred to in *In re Rhone-Poulenc Rorer Inc* 51 F3d 1293 at 1298 (7th Cir 1995) per Posner CJ.

[107] *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 ALR 58; 80 ALJR 1441 at [1] and [146].

[108] *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 ALR 58; 80 ALJR 1441 at [287]. The dissentients considered the characteristics of the particular funding agreement in reaching their decision but one factor which clearly stood out was that "[t[he purpose of court proceedings is not to provide a means for third parties to make money by creating, multiplying and stirring up disputes in which those third parties are not involved and which would not otherwise have flared into active controversy but for the efforts of the third parties, by instituting proceedings purportedly to resolve those disputes, by assuming near total control of their conduct, and by manipulating the procedures and orders of the court with the motive, not of resolving the disputes justly, but of making very large profits". *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 ALR 58; 80 ALJR 1441 at [266].

[109] Standing Committee of Attorneys-General, *Litigation Funding in Australia* (May 2006).

Uniformity in State laws is desirable to avoid forum-shopping and so the position as to maintenance and champerty should be made uniform across Australia. However, it is also understandable that those jurisdictions who retain the torts or crimes of maintenance and champerty may see them as a brake on the litigiousness that litigation funding promises. Consequently, a lack of uniformity is possible.

The courts that had dealt with litigation funding before *Fostif* had set out various criteria that they measured a funding arrangement against to determine if it was an abuse of process or it was contrary to public policy. The criteria included matters such as: whether there is a direct retainer and costs agreement between the plaintiff and the solicitors; whether the solicitors were chosen by the plaintiff; whether there has been adequate disclosure to the plaintiff by the funder; whether the funder has excessive control over proceedings; and whether the funder has liability for the successful defendants' costs.[110] SCAG's discussion paper sought comment on whether these factors should be formalised. However the joint judgment considered some of these factors and dismissed them as being irrelevant.[111] To ensure protection of consumers and that the real plaintiff does not lose control of the proceedings to the funder a set of acceptable terms for a funding agreement is needed. In the meantime it is to be expected that funders will seek to take greater control of proceedings so as to better protect their investments.

There also needs to be prudential regulation which ensures that litigation funders are entities of substance. The judicial system, plaintiffs and defendants will be severely harmed if a funder becomes insolvent in the middle of a matter. The brake on unmeritorious litigation that the cost rules provide by requiring an unsuccessful party to pay the other side's costs are ineffective if a litigation funder is a "man of straw" unable to pay an adverse costs order.

Litigation funding, depending one ones perspective, is advocated on the basis of providing access to justice or criticised on the basis that it promotes litigiousness.[112] Either way litigation funding is likely to increase the amount of securities class action activity because there are resources available for identifying and prosecuting potential law- suits.

CONCLUSION

It is only in the last five years that shareholder activism has taken the form of class actions. The growth in shareholder class actions is being driven by:

[110] See eg, *Clairs Keeley (a firm) v Treacy* (2003) 28 WAR 139 and *Project 28 Pty Ltd v Barr* [2005] NSWCA 240.

[111] *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 ALR 58; 80 ALJR 1441 at [88].

[112] Carman Yung, Litigation funding: officious intermeddling or access to justice? (2005) 15 *Journal of Judicial Administration* 61 at 80 ("professional litigation funding is not intended to be altruistic. The overriding objective of the industry is the maximisation of profits").

- a consumer protection approach to corporate law, demonstrated by the erosion of maintenance of capital as central principle;
- broad statutory causes of action based upon the consumer protection standard of misleading or deceptive conduct.
- the continuous disclosure regime creating a source of actionable representations or omissions;
- a greater willingness on the part of Australian shareholders to seek a legal remedy;
- a plaintiff-friendly class action procedure; and
- litigation funding.

Australia is now the most likely location for class action litigation outside the United States.[113]

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[113] Sundeep Tucker, "Culture of Class Action Spreads Across Australia", *Financial Times* March 9, 2006, p 12.