Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600

Re: Litigation funding and the regulation of the class action industry

The following arguments relate primarily to your terms of reference numbers 8 and 9 and focus on the suitability of allowing shareholder class actions. It is my argument that Shareholder Class Actions make no sense. Class actions generally make sense. Shareholder class actions make no sense at all.

Some will argue that shareholder class actions assist in achieving market discipline of public companies. Where continuous disclosure requirements have not been observed and shares purchased by new investors in a company fall in value once disclosures are made, the company will be at risk of shareholder class actions. While shareholder class actions have become more common in the continuous disclosure regime, I am not aware of evidence (although there may be some) that they have contributed to improved disclosure by companies. And they are a resource intensive costly exercise where litigation funding arrangements can lead to proliferation of cases which may not be warranted. It is not clear that they are an efficient means of trying to achieve market discipline in relation to corporate disclosures.

Class actions enable a group of individuals who have suffered similar losses to band together and share the costs of legal action in pursuit of compensation which would otherwise be infeasible. Litigation funders further facilitate that process through fee structures which link their remuneration to outcomes achieved.

In this way, the imbalance in financial resources between individual claimants and large defendants which would otherwise inhibit the former taking legal action because of the costs and risks involved, is significantly reduced. If successful, claimants can expect to be compensated for loss or hurt at the expense of those whose actions were responsible.

Class actions against manufacturers of harmful or defective products are clearly warranted on these grounds. Although the ultimate cost will probably be borne by shareholders in such firms, who most likely had no knowledge of the product failings, they have arguably benefited from the profits gained from sales of those products.

But shareholder class actions are an entirely different kettle of fish. These generally involve as plaintiffs a group of investors who purchased a company's shares on the stock exchange over some period when the company knew, but had not publicly disclosed, some negative information about itself.

The argument is that those "new" investors bought the shares at what was subsequently seen to be an inflated price due to the non-disclosure of that information. They consequently suffered a loss when disclosure occurred and the share price fell. Listed companies are required to provide continuous disclosure of material information, and thus arguably have breached those requirements.

If successful, those "new" shareholders will receive compensation ordered by the court from the company. This negative impact on the company's capital (shareholders funds) can be expected to cause a fall in the company's share price, at the expense of the existing shareholders. (This may have already happened before any court judgement through market expectations of the likelihood of a successful claim).

The fallacy involved in permitting such shareholder class actions is easily seen. It is the previous shareholders who sold their shares to the "new" shareholders who benefitted from the sale at an inflated price. They are no longer shareholders (or have a lower stake) in the company. Unfortunately, it is probably impossible to design a system where compensation of the new shareholders is funded by "clawing back" funds from that group of sellers!

Any penalties awarded against the company fall on remaining shareholders, not those who exited by sales at inflated prices. And the remaining shareholders have not, except to the extent of any excessive dividends paid out, benefited from the inflated prices. When the adverse information was eventually disclosed, the value of their shares would have fallen accordingly.

Not only would they have been unaware of the inadequate disclosure (since they had retained their shares), they suffer a loss (from share price decline) upon disclosure and then further loss from any court-awarded penalties. That does seem a little like double jeopardy!

So what underpins this ludicrous situation of allowing such shareholder class actions? It would appear to reflect an idealised model of public company governance which is far divorced from reality. In that model, shareholders and management are one and the same, or management simply implements decisions made by the shareholders.. In that idealised model (perhaps relevant in early corporate history or where there is a dominant, controlling, shareholder), allowing such actions which penalise those shareholders can make some sense.

But, the reality could not be more different in the modern, real, world where boards and management of public companies are largely autonomous, acting out their own agendas. Occasionally shareholders might revolt and have an influence, but the more appropriate model is one of diffused, uninvolved, shareholders who are better regarded as simply being investors.

In that world, the deterrent and punishment effects of the legal system need to be more directed towards actions and outcomes for boards and management. While it might be argued that shareholder class actions may also impact upon those individuals, they are at best an extremely blunt and much delayed weapon.

It may be the case that the ability of company's to take out directors and officers liability insurance or other forms of insurance against losses due to class actions means that the specific loss associated with a successful action does not fall directly on existing shareholders. However, this contributes to the rising cost of such insurance, and is a burden on all shareholders via the premiums paid for such insurance. The penalties for inadequate disclosure by some companies are spread across shareholders in all companies.

It is important that share markets are well informed to assist efficient allocation of financial resources and disclosure requirements are part of that. Effectively enforcing them is not simple, but it is far better to ensure that regulators are adequately empowered and resourced to quickly take action against those who are responsible, rather than shareholder class actions primarily affecting those who are not. In this regard, the recent introduction of the Executive Accountability Regime provides an additional opportunity to directly hold accountable those responsible for meeting disclosure requirements, rather than via shareholder class actions.

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