1 December 2023

echo law

SUBMISSION TO CONTINUOUS DISCLOSURE: REVIEW OF CHANGES MADE BY THE *TREASURY LAWS AMENDMENT (2021 MEASURES NO. 1) ACT 2021*

Introduction

1. Echo Law is a plaintiff law firm, specialising in class actions against established interests. The firm was formed in 2022, by three senior class actions practitioners who have each worked in the sector for over a decade. Echo Law's structure embeds equitable values which seek to further the use of the class actions vehicle as a tool for promoting social justice – every dollar returned to owners must be matched by a dollar in profit-share to staff, and a dollar to public interest or strategic litigation.

2. We make this submission with reference to our extensive experience in shareholder class action litigation, with the firm's partners having acted for shareholders in successful claims against several ASX-listed entities. This submission is directed towards the questions set out in the Review Consultation Paper concerning the impact of the changes to the 2021 Amendments on class actions arising from contraventions of the legislative framework.

3. Echo Law has grappled with the impacts of the changes to the continuous disclosure and associated provisions over the past 3 years, and we are of the view that the changes erect additional procedural barriers which can add to the cost of running shareholder class action litigation.

4. We submit that the 'fault element' requirements that require a plaintiff to establish that a Company acted recklessly, negligently or knowingly with respect to whether information in its possession was material and disclosable should be removed from the relevant legislative frameworks. In our submission, this change will reduce the cost to group members of and delays in shareholder claims, and ensure that companies which withhold material information from the market and cause meaningful losses to shareholders are held to account.

5. From a policy perspective, the use of a 'fault' or 'state of mind' requirement weakens the consistent application of the continuous disclosure regime to ASX-listed companies, which is otherwise concerned with more objective facts of materiality and knowledge.

Shareholder class actions

6. The reforms to the continuous disclosure obligations which exist for ASX-listed entities were underpinned by a view formed by the Parliamentary Joint Committee on Corporations and Financial Services, informed by the business lobby, that shareholder class actions are opportunistic and detrimental to ASX-listed corporations and their shareholders.

7. This report was produced in the context of a broader attempt by the former Government to stifle class actions in Australia, including by characterising litigation funding arrangements as 'managed investment schemes'.

8. ASX-listed entities enjoy several benefits of public listing – the ability to raise capital principal among them. The obligations placed on these entities are not onerous, in circumstances where the efficient functioning of the market depends on the timely disclosure of price sensitive information to ensure that the price paid by investors for shares reflects the true underling value of a corporation's earnings.

9. It is only in instances where there is sufficient evidence available to demonstrate that a company has misled the market or failed to disclose material information in a timely manner that companies become subject to enforcement action or claims for damages. Class actions do not simply arise because a company has released negative information to the market – so long as that disclosure is timely, and statements are made with a reasonable basis, there is no recourse against a company or its directors.

10. Class actions can only be commenced in circumstances where solicitors and barristers form the view that there is a proper basis to claim that a company has not complied with these obligations. Significant time is spent investigating claims, and many such investigations do not result in litigation – there being too little evidence to support a view that the relevant provisions have been breached, or insufficient losses to justify the expense of bringing the claims through the class action vehicle.

11. Shareholder class actions typically relate to a period of non-disclosure spanning at least several months – belated disclosure of material information which is limited to a matter of weeks means that a relatively small number of investors have purchased shares at an inflated price, rendering the losses too minimal to justify a class action. It is therefore not the case that opportunistic claims are pursued where the conduct in question is at the less egregious end of the conduct spectrum.

12. Class actions are pursued on behalf of shareholders against ASX-listed entities when companies have misled the market, or failed to disclose material information. Good governance, and an approach to compliance which prioritises frank and timely disclosure above promising unachievable earnings targets (and the remuneration and share price inflation which are motivating features of non-compliance) ensures that the vast majority of ASX-listed entities are not subject to shareholder class actions.

13. As at October 2023, since 2016, 91 shareholder class actions have been issued in various Australian jurisdictions. This total includes 57 unique companies – with some subject to multiple claims in relation to the same conduct, and a smaller group sued multiple times in relation to different conduct/periods.

14. On average, 7 unique ASX-listed entities have been subject to a class action per year over 8 years.

15. At the time of writing, 2769 companies are listed on the ASX. The total number of unique companies subject to a shareholder class action over the 8 year period equates to 3% of the total number of listed entities – or 0.2% on a per year basis.

16. The notion that shareholder class actions are increasingly prevalent, or that they are triggered with 'ease' as suggested in the PJC report is plainly misplaced when considered in the context of the data relating to the preponderance of these claims.

17. The relatively small number of claims when considered in this context is explained by the material risk which exists for litigation funders or law firms in pursuing unmeritorious or 'opportunistic' shareholder class action claims.

18. The existence of adverse costs orders in Australia sets the class action regime apart from that in the United States, where the absence of a 'loser pays' system substantially reduces the risk to plaintiff law firms which commence shareholder class actions.

19. In Australia, the prospect of law firms or litigation funders being required to pay the legal costs of a defendant if the case is unsuccessful – which in shareholder class actions range from $5m - $10m – looms large in the decision to pursue a claim. The existence of adverse costs orders therefore acts as a deterrent which prevents vexatious or opportunistic claims with limited prospects being commenced.

20. Litigation funders and law firms also bear the costs of funding the litigation, which costs are not recoverable if the class action is not successful. Typically, group members are not called upon to contribute their own funds to financing the class action, and are not charged a fee if the claim is unsuccessful. This acts as a further deterrent on the pursuit of unmeritorious claims – there is substantial risk of significant financial losses if the claim is not ultimately successful.

2021 Amendments

21. The 2021 Amendments as applied to s 674 and s 1041H of the *Corporations Act* require the plaintiff to establish that if:

    (a) a company knew or ought to have known information; and

    (b) that information was in fact material to the market's assessment of the price or value of a company's shares; then

    (c) the company knew, or was reckless or negligent as to whether the information was material.

22. The approach to giving effect to the 2021 Amendments was to change s 674 (which does not include the fault elements) so that it is no longer a civil penalty provision, and to instead introduce a new s 674A (which does include the fault elements) as a civil penalty provision.

23. The 2021 Amendments have necessitated additional allegations or pleas to address incorporate the fault elements in a claim. Pleading recklessness or negligence is typically achieved by reference to the following matters:

    (a) The awareness of one or more company officers of the non-disclosed information;

(b) The materiality of the information (by reference to the impact on the price of the company's securities of the eventual disclosure of the information);

(c) The fact that the company did ultimately disclose the information; and

(d) The price impact of the information.

24. Plaintiffs then plead that it is to be inferred from these matters that a company:

(a) was aware of a substantial risk that, if it were generally available, the information would or would be likely to influence persons who commonly invest in securities in deciding whether to acquire or dispose of the securities;

(b) was aware of a substantial risk that, if it were generally available, the information would have a material effect on the price or value of the securities;

(c) ought reasonably to have known or by the exercise of reasonable care would have known that the information would or would be likely to influence persons who commonly invest in securities in deciding whether to acquire or dispose of the securities;

(d) ought reasonably to have known or by the exercise of reasonable care would have known that the information would have a material effect on the price or value of the securities.

25. In reality, evidence of a company's knowledge of the non-disclosed information, coupled with its objective materiality, will in most cases form a sufficient basis for establishing that a company was at least reckless or negligent as to whether the information was material.

26. However, the introduction of the fault elements in relation to the question of materiality creates an additional layer of proof pertaining to the subjective mind of the company's officers. It is an additional threshold that, from an evidentiary perspective, creates unnecessary challenges for shareholder claims. The prospect of identifying a document which records a company officer stating a view that 'this information will materially impact our share price' is negligible.

27. Whilst it is likely to be possible to establish recklessness or negligence (if not actual knowledge) by reference to contextual information, including the objective fact of the actual share price movement when the information was finally disclosed, the added time and expense of proving this additional element is not justified. Witnesses will be required to adduce evidence of their state of mind, and come under cross-examination at trial in order for the cause of action to be complete.

28. To provide an example, say a company had in August 2023 provided guidance to investors for $200m in earnings in FY24, and by November 2023 knew or ought to have known that it had lost a material contract worth $40m to earnings and had no way of plugging that gap. It did not disclose this information until April 2024, and at that point the share price declined 15%.

29. In this scenario, assuming the plaintiff can prove that the Company knew or ought to have known that it had lost the contract and could not recover the lost earnings, and could point to the material price reaction when the information was ultimately disclosed (along with relevant expert evidence) – the final step as required by the 2021 Amendments requires the plaintiff to demonstrate that the company's officers were aware of a substantial risk that the information would be likely to influence investors' investment decisions, or by the exercise of reasonable care would have known that the information would influence investors' investment decisions.

30. Shareholder class actions are not concerned with non-disclosed information which is not material to a company's share price. It is only in cases where the information is sufficiently important to shareholders' views about the value of the company's earnings that the share price will be impacted when such information is disclosed.

31. The notion that a company officer possessed of such information would not appreciate its significance to the share market is a fallacy. And yet, the 2021 Amendments require plaintiffs to adduce evidence of the company's officers' state of mind as to the information's materiality, having already established that the company withheld information that was objectively material to the share price.

32. In our view, the time and expense attributable to meeting this additional threshold is not justified, in circumstances where the plaintiff will have, at that point, already demonstrated that the company was possessed of objectively material information.