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Class Action RISK 2018

Class action filings have continued to rise. More class actions have been filed in 2017 and 2018 than ever before.

The primary driver for this trend is more and more plaintiff lawyers and third party funders bringing class actions in the hopes of sharing in the spoils of a substantial settlement (or, very occasionally, a judgment).

It is extraordinarily challenging for companies to assess class action risk in this rapidly changing environment. While filings are one indicator of class action risk, a proper assessment requires a holistic assessment of the broader class action landscape.

To provide that broader context, and give practical guidance to those responsible for assessing and managing class action risk, in this latest edition of our Class Action Risk reports we have provided an overview of the indicators and drivers of class action risk, with a particular focus on the way in which the class action landscape has changed over the course of the past two years.

Key points

UNPRECEDENTED SPIKE IN FILINGS

There has been an unprecedented spike in class action filings in the past two years. In part, this is the result of competing filings against the same companies in respect of the same issues. But, even when those competing filings are stripped away, there are still more companies facing class actions than in prior years.

BIGGEST SPIKE IN SHAREHOLDER CLASS ACTIONS

The increase in filings in recent years is almost entirely attritutable to shareholder class actions, with those claims accounting for roughly 50 per cent of all class actions filed since the beginning of 2017. This makes being an ASX-listed company the biggest indicator for class action risk.

BANKING AND FINANCIAL SERVICES SECTOR BIGGEST TARGET

The banking and financial services sector experienced the highest incidence of class action filings in recent years. Other sectors with a high incidence of claims include industrials, infrastructure, power and government.

It is likely that we will continue to see a high prevalence of class actions in the banking and financial services sector in light of the issues exposed during the Royal Commission. Although the Commission's final report is still a number of months away, we are already seeing announcements of class actions under investigation.

DRIVEN BY ENTREPRENEURIALISM

The defining feature of the current class action landscape is increasing entrepreneurialism. More than ever before, class actions are being seen as lucrative profit making enterprises for plaintiff lawyers and litigation funders.

There are, however, also indications that the courts are recognising this trend and taking steps to address some of the most concerning elements. In particular, there are increasing signs that the courts are recognising that class actions are being driven by promoter interests and are looking to restore the focus on class member interests. Generally speaking, we think this trend is also in the interests of class action defendants and will go some way to restoring an effective package of checks and balances.

POTENTIAL REFORM

The Australian Law Reform Commission is undertaking a searching review of class actions and litigation funding practice, and has already raised some important proposals for consideration – many of which are directed at reining in the effects of entrepreneurialism.

The most important (and controversial) of the ALRC's reform proposals is for a review of continuous disclosure obligations in light of the evolving shareholder class action landscape. In our opinion, this is an incredibly important and sensible proposal that could lead to meaningful change without watering down a listed company's continuous disclosure obligations. As discussed on page 6, we think meaningful change could be effected by making a right to damages in shareholder class actions dependant on proof of intentional misconduct or negligence in the disclosure process.

RESPONDING TO CLASS ACTION RISK

If a class action is commenced against your organisation, you are likely to face a period of difficult and sustained litigation (irrespective of the merits). Even in this entrepreneurial environment, it is important to resist knee-jerk reactions and to instead engage in an objective assessment of risk from day one. As a preventative measure, it is also important to be conscious of the types of conduct that may give rise to class action risk in your business and to ensure that appropriate systems are in place to minimise the risk of that conduct occurring. It is also prudent to have plans in place so that, in the event that something goes awry, the response can be swift and based on an objective assessment of risk. See our framework for considering and assessing class action risk on page 7 for more detail.

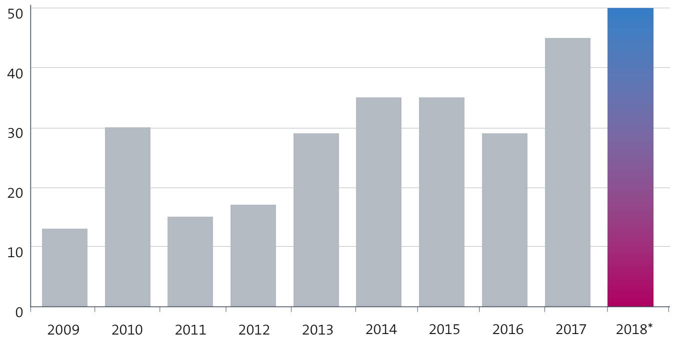
The big picture – class action filings

The bottom line is that class action filings continue to increase. As can be seen from Figure 1, that trend has been building since about 2013, but has been taken to a new level in 2017 and 2018.

The class actions filed in recent times have included:

- shareholder claims against AMP, GetSwift, CBA, Woolworths, BHP, Iluka, UGL, Sirtex, Crown and Brambles;
- a range of product liability claims – in particular relating to Takata airbags and medical devices;
- a number of class actions against the banks and financial services firms – including the first few cases in relation to issues exposed during the Royal Commission;
- various claims against government including in respect of construction projects, quality of service and environmental issues; and
- a growing number of class actions against employers on behalf of their employees (including the first privacy claim).

Figure 1 – Class action filings



* Annualised based on filings to 31 October 2018.

As always, raw statistics can present a misleading picture of what is happening. In our opinion, two ways in which the data can be viewed to provide greater insight into the current environment are (1) the types of claims being filed; and (2) the number of filings that are 'competing' – that is, when a filing represents the second, third, fourth or fifth class action against a company in relation to the same or related issues (with each claim being filed by a different law firm). Our analysis through those lenses is below.

FILINGS BY TYPE

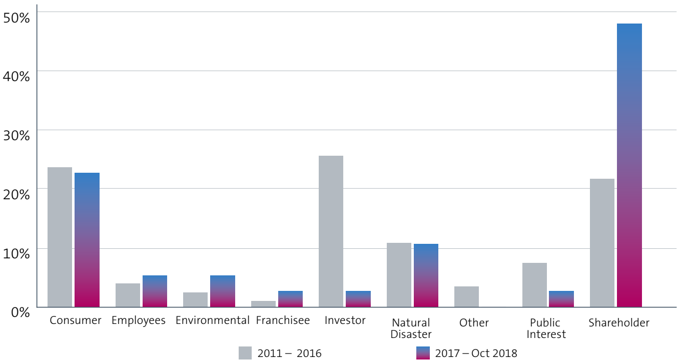


Figure 2 – Filings by type by percentage

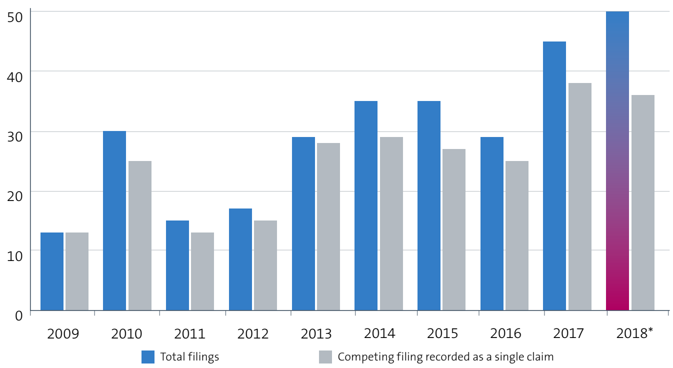
Figure 2 highlights the starkest of trends: while shareholder class actions[1] have comprised roughly 20 per cent of class action filings over the past decade, they have accounted for almost 50 per cent of filings in 2017 and 2018.

The driver for this trend lies not in a massive rise of continuous disclosure indiscretions, but in the increasingly entrepreneurial and opportunistic culture surrounding shareholder class actions (as discussed further on page 4).

The other trends that can be identified from Figure 2 include:

- Investor class action filings have fallen significantly in recent times. This is the result of the spike in claims arising from GFC related losses reaching its natural end. It is, however, becoming increasing clear that issues coming out of the Royal Commission will give rise to a new round of investor claims. There are already early indicators that this will give rise to more claims on behalf of more class members.
- Most other categories have remained remarkably steady, with only the immaterial fluctuations expected to be seen over time.

COMPETING FILINGS



* Annualised based on actual filings to 31 October 2018.

Figure 3 – The effect of competing filings

In Figure 3 we have reproduced the filings data from Figure 1 (in blue) but also shown the level of filings in a way that strips out the competing class actions to record each instance in which a company is faced with multiple claims in respect of the same or similar issues as a single claim (in grey).

This shows that, while competing class actions are having a material influence on filings data (particularly in 2018), the increase in filings described above cannot be explained away as wholly attributable to the competing class action phenomenon.

1 The category of 'shareholder class action' is limited to those cases that arise from an ASX–listed company's disclosures to the market. The allegations made in these cases arise from an alleged breach of continuous disclosure obligations and/or alleged misleading or deceptive conduct in the disclosures made to the market.

Who is most at risk?

A key reason for publishing this report is to help our clients assess their risk of facing a class action. With that in mind, we have looked at whether any particular organisations or industry sectors are more prone to class action risk than others.

ASX-LISTED COMPANIES AT HIGHEST RISK

With shareholder class actions accounting for almost 50 per cent of class actions commenced since the beginning of 2017, the biggest indicator of class action risk is being an ASX-listed entity.

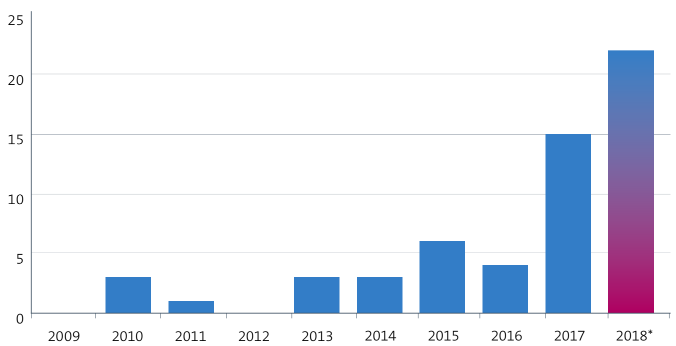
Shareholder class actions assumed a new significance in 2017 – twice as many shareholder class actions were filed in 2017 than in any prior year. Current filings suggest a new high-water mark will be reached in 2018.

Much can be attributed to what the ALRC has described as the 'standard approach' to the pursuit of shareholder class actions[2] which, in essence, involves an assumption that a drop in a company's share price in response to a market disclosure gives rise to a reasonable basis for an allegation that there has been a breach of the company's continuous disclosure obligations (and/or misleading or deceptive conduct).

Assumptions of this kind (no matter how flimsy or well-founded) are the basis for most shareholder class actions, and give rise to a level of risk that invariably leads to a settlement.

This, in turn, creates a risk reward scenario that is extremely attractive to those interested in the commercial opportunities presented by the business of shareholder class actions and is resulting in more companies facing shareholder class actions than ever before.

Figure 4 – Shareholder class action filings



* Annualised based on actual filings to 31 October 2018.

ROYAL COMMISSION CLAIMS

The banking and financial services sector will face additional class action risk as a result of the issues raised in the course of the Royal Commission.

A number of claims have already been commenced or foreshadowed as a direct result of issues made public by the Commission including in respect of superannuation fees and returns, life insurance, credit card insurance and the so-called 'fee for no service' issues. The five shareholder class actions against AMP were also triggered by the market reaction to information coming out of the Commission.

Plaintiff lawyers are investigating a broad range of potential class actions with the benefit of the tomes of material made public during the Commission. It is also no secret that litigation funders have been out in force looking for the most viable claims, and the potentially large number of affected persons are likely to make many of these claims highly attractive.

While some foreshadowed claims will fall by the wayside, in this current entrepreneurial environment and with the benefit of the 'leg up' provided by the Commission, it is highly likely that the banking and financial services sector will be under sustained class actions pressure for at least the next three or four years.

THE SECTORS MOST AT RISK

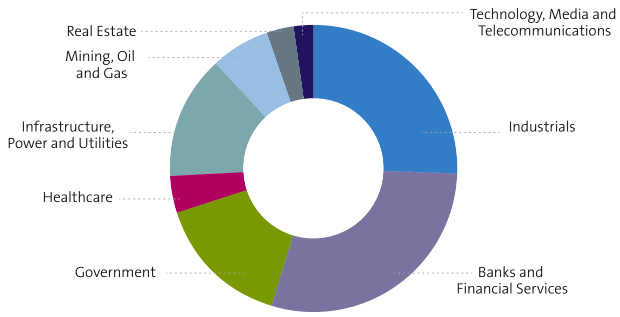


Figure 5 – Class action filings by industry sector

It is difficult to draw any firm conclusions about class action risk on a sector basis. The fact is that a broad cross-section of industry sectors are at risk of facing a class action from time to time, and that risk will often attach to specific events or cycles rather than core operations. That said, we make the following observations:

- The highest incidence of claims over the past five years is in the banking and financial services sector. The vast majority of the claims contributing to that outcome arose from losses associated with the GFC. The issues raised in the Royal Commission are likely to result in the continuation of this trend (at least). Moreover, extraordinary events aside, this sector's significance to our economy and the public facing nature of its business means that it will always be the subject of sustained class action activity.
- The sector with the second highest incidence of claims in the relevant period is industrials (which includes manufacturing, retail, agriculture, business services, food & beverage, etc). Within that sector, the highest concentration of claims was against motor vehicle manufacturers – including, for example, the separate clusters of claims in relation to airbags and emissions limiting devices.
- The third highest incidence of claims is in the government sector. This incorporates a broad range of claims, including in respect of groundwater contamination, immigration, quality of services, employee and natural disaster.
- Infrastructure, power and utilities run a close fourth. Within infrastructure, the vast majority of the claims are shareholder or investor class actions; whereas almost all power and utilities class actions have related to natural disasters (bushfire and flood).
- The technology, media, and telecommunications sector has proven to be remarkably immune to class actions in recent years. Although we question whether that will remain the case given the increasing focus on (and obligations to disclose) data breaches.

2 See also the description of the architecture of a shareholder class action in Jenny Campbell and Jerome Entwisle 'The Australian Shareholder Class Action Experience: Are We Approaching A Tipping Point?' (2017) 36(2) *Civil Justice Quarterly* 177.

The increasing commercialisation of class actions

The defining feature of today's class actions environment is promoter (plaintiff lawyer and funder) entrepreneurialism. Put simply, more than ever before, class actions are seen as lucrative profit-making opportunities for plaintiff lawyers and third party funders. This increased commercialisation is a key driver of class action risk.

Two of the starkest examples of promoter entrepreneurialism are the five competing class actions against AMP Limited and the three competing class actions against GetSwift. In the context of the AMP cases, the Chief Justice of the Federal Court recently acknowledged, in more express terms than ever before, that the problem of competing class actions is really a problem of the competing interests of the different promoters.

THE SIGNS OF INCREASING COMMERCIALISATION

There are four objective indicators of increased commercialisation in the Australian class actions landscape:

1. class action filings are materially increasing in circumstances in which there is no suggestion of an equivalent increase in contravening conduct by Australian businesses
2. an increasing number of law firms are filing class actions – including some that have traditionally been considered commercial (or defendant) practices
3. an increasing number of third party litigation funders financing class actions
4. all of the above have contributed to the most incontrovertible indication of increasing commercialisation – the increasing number of competing class actions.

PLAINTIFF LAWYERS

An essential contributor to the increasing commercialisation is the increasing number of law firms looking to bring class actions. This includes newly established firms (some with principals with extensive class action experience), existing firms of all shapes and sizes with no prior class action experience, and firms that might traditionally have been considered commercial (or defendant) firms.

It remains to be seen how this trend may be affected if the law is changed to allow lawyers to charge contingency fees in class actions. The one certainty is that offering lawyers the opportunity to be remunerated by reference to a percentage of the outcome of class action litigation is not going to reduce the number of firms looking to get a slice of the action.

HOW DOES THIS COMMERCIALISATION AFFECT CLASS ACTION RISK?

Additional promoters looking to get a piece of the class action pie will obviously bring additional capacity to the market, which results in increased filings. However, the increasing commercialisation is also increasing class action risk in more subtle ways, including the following:

- Increasing instances of 'claims mining' (ie, claims driven by profit-making opportunities for the promoters rather than the pursuit of compensation for people wanting to bring a claim). Indeed, we do not see it as an exaggeration to say that justice for class members is often nothing more than a convenient 'by-product' of many class actions. This is particularly the case in shareholder class actions, but there are other examples in which a reasonable observer would form the view that the claim was brought primarily for the benefit of the promoters.
- The increased capacity is resulting in more speculative claims being commenced. We are increasingly seeing cases commenced on a punt that, even if the case turns out to be unmeritorious or beyond the capacity of the lawyers, there is a good chance that there will be an opportunity to settle at a level that is rational for the defendant to shut down the exposure and move on (but still provides a healthy return for the promoters).

THIRD PARTY FUNDERS

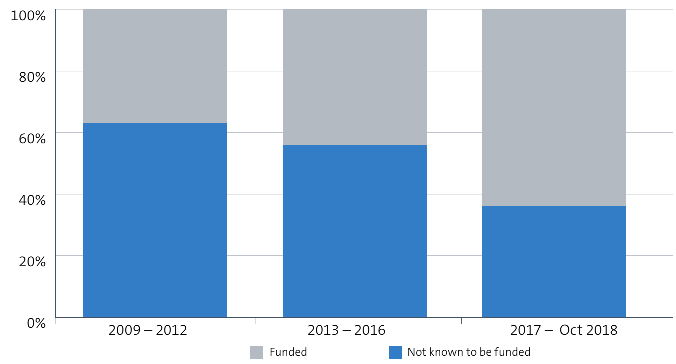


Figure 6 – Percentage of cases funded

We continue to see sustained increases in the number of class actions that are funded and also the number of local and offshore funders investing in Australian class actions.

Accurate information about funding arrangements is not always publicly accessible, but by our reckoning:

- Roughly two-thirds of recently commenced class actions are third party funded, which is a material increase on prior periods. What's particularly notable about this trend is that the percentage of funded cases has grown at the same time as class action filings have materially increased. This suggests a very significant increase in funding dollars being invested in Australian class actions.
- There are approximately 20 funders active in the market at the moment. By comparison, less than 10 funders were active five years ago.
- Third party funders have a clear preference for certain types of class actions. In particular, they favour shareholder class actions. Other preferred claims are consumer and investor class actions. In that context, we know that they are investigating Royal Commission related claims.

While there is no sign that third party funders' appetite for Australian class actions is diminishing, there are indicators of the market changing in a way that may mean that the enterprise may not continue to be as lucrative as it has been in recent years. These indications include the following:

- The Federal Court (in particular) has started to take a more interventionist role in considering the appropriateness of funding commissions.
- The courts' efforts to grapple with competing class actions have also led to a dramatic decrease in the funding commissions sought in those cases as promoters fight to have their case selected as the case to proceed.
- We have also started to see novel funding models, such as a funder's return being calculated by reference to a multiple of costs expended rather than as a percentage of the amount recovered.

There are also new questions being asked about the courts' powers to make 'common fund' orders (funders' preferred model) which will be heard by appeal courts in the coming months (and may ultimately be determined by the High Court).

Agenda for reform

The increasing commercialisation of class actions has led to increasing calls for reform.

Commercialisation (or entrepreneurialism) is not in itself a bad thing. Indeed, the courts and legislatures have long recognised that it is an essential ingredient in facilitating access to justice. It is, however, only a means to an end and should only be permitted to the extent that it facilitates, rather than undermines, the objectives of the class actions regime.

While we have been pointing to increasing entrepreneurialism as increasing class action risk for a number of years, we had been comfortable that the checks and balances in the system had been reasonably effective in disincentivising highly speculative or unmeritorious claims. There is, however, growing evidence that recent experience has us fast approaching a 'tail wagging dog' scenario – by which we mean that the promoters' pursuit of profits has become an end in itself and is no longer supporting the objectives of the class action regime.

That said, there are encouraging indications that the courts are recognising this shift and taking steps to address some of the most concerning trends through more interventionist case management practices. It is also at the core of the ALRC's review of class action and litigation funding.

Against that background, the issues most ripe for reform include the following:

- the approach to managing competing class actions – including whether there are ever any circumstances in which more than one case should proceed. This issue is currently being considered by the Federal Court, Supreme Court of NSW and the ALRC;
- the way in which both plaintiff lawyers and litigation funders are remunerated for their role in class actions – the changes that would have the biggest impact are additional court supervision of funding commissions and legal costs incurred on behalf of the class; and
- change to the cause of action underpinning shareholder class actions – see the box below.

The other major reform that should not be overlooked in this context is the increasing likelihood of the prohibition on plaintiff lawyers charging contingency fees being lifted (at least in class actions). As noted on the previous page, it remains to be seen how this would affect the class actions funding market, but there is little prospect that it will result in less lawyers looking to pursue class actions.

The ALRC's review

In December 2017, the Attorney-General asked the Australian Law Reform Commission to consider whether further regulation of class actions and/or litigation funders was required.

The ALRC issued a Discussion Paper in June 2018 in which it sought to grapple with the nature and drivers of the class action regime. That paper proposed some significant reforms with a view to realigning the modern class actions regime with its original objectives. Some of the ALRC's more notable proposals for reform include:

- a review of the legal and economic impact of continuous disclosure obligations in light of the evolving shareholder class action landscape
- the introduction of a licensing scheme for litigation funders
- permitting solicitors to enter into contingency fee agreements in class action proceedings
- giving the court power to choose a single claim to proceed when competing class actions are filed
- introducing a Federal collective redress scheme to provide compensation to a group without the need for litigation

The ALRC called for submissions in response to its proposals for reform by interested parties. You can read a summary of our submissions here: *Allens' submission to ALRC Class Actions Inquiry: Time to revisit the checks and balances*.

The ALRC has its work cut out for it in sifting through and analysing the 50+ submissions it has received which, not surprisingly, express a broad range of strongly-held views in relation to the health of the current class action environment and the proposals for reform. It is due to produce its final report by 21 December 2018, but word on the street is that it is on track to beat the deadline.

The most meaningful reform – introducing culpability to shareholder class actions

The most controversial of the ALRC's reform proposals is a review of continuous disclosure obligations in light of the evolving shareholder class action landscape. In our opinion, this is an incredibly important and sensible proposal that could lead to meaningful change without watering down a listed company's continuous disclosure obligations.

As we see it, the issue most ripe for reform in this context is the fact that a private right of action currently arises without need to establish (or even allege) any form of intention, fault or negligence on the part of the company. It would better align with the objectives of the regime and serve the interests of the investing public if a private right of action was limited to circumstances in which there is a degree of management fault or culpability (including negligence) in the alleged disclosure contravention.

Consideration could also be given to other amendments to the private right of action with a view to limiting that right to those shareholders who have truly suffered loss by reason of the alleged conduct, including by:

- expressly limiting an entitlement to damages to shareholders who prove that they relied upon the alleged conduct in making their investment decision; and
- capping damages in circumstances in which the share price rebounds quickly after the relevant price decline in an attempt to limit damages to losses caused by the contravention rather than unrelated market conditions.

At this stage, there has been no indication as to whether there is any appetite within the Federal Government to take up the ALRC's proposal for a review. We will, however, continue to advocate for reform on behalf of our clients.

A framework for considering and assessing class action risk

Having regard to the trends identified in this report and our broader experience, we recommend that class action risk be considered through the following lens:

- Class action risk is continuing to increase – more claims are being filed and more law firms and funders are promoting claims.
- However, a proper assessment of class action risk requires looking behind the headlines and raw data. We are becoming increasingly concerned about the effects of entrepreneurialism in the class action context. This does not, however, detract from the fact that many class actions (even those that are pursued primarily for the benefit of the promoters) give rise to significant exposure.
- If a class action is commenced against your organisation, you are likely to face a period of difficult and sustained litigation (irrespective of your assessment of the merits). The class action may raise complex legal and strategic issues, be a significant drain on financial and management resources, and potentially damaging from a reputational perspective. The mere threat or launch of a class action can also have similar consequences.
- Even in this increasingly entrepreneurial environment, it is important to resist knee-jerk or otherwise dismissive reactions to the threat of a class action and instead to engage in an objective assessment of the risks from day one. To do otherwise puts you at a strategic disadvantage and can impede an effective response to the claim (even if it is speculative).
- As a preventative measure, it is important to be conscious of the types of conduct that may give rise to class action risk in your business and, consistent with good risk-management practice, to ensure that appropriate systems are in place to minimise the prospects of that conduct occurring. It is also prudent to have plans in place so that, in the event that something goes awry, the response can be swift, measured, based on an objective assessment of the situation and not inflame the associated class action risk.
- Class actions are a specialised form of litigation. Entrusting your organisation's response (including the associated crisis management) to lawyers who are not class action experts involves unnecessary risk and puts the company at a significant strategic disadvantage.

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How do we view class action risk in late 2018?

Class action risk is continuing to increase – more claims are being filed and more law firms and funders are promoting class actions. This risk is particularly pronounced for listed companies, which should assume that any disclosure that is followed by a share price fall will be closely scrutinised by class action promoters.

At a more holistic level, the class actions landscape is at a tipping point. Over the last year or so it has teetered dangerously close to the edge as promoter interests have been increasingly pursued at the expense of class members. This had (and has) the potential to lead to a very significant increase in class action risk. There are, however, signs that both the government (through its referral to the ALRC) and the courts (through their case management practices) have recognised the danger and the need to take steps to address it.

Of course, it remains to be seen whether meaningful reform can be achieved against the loud and repetitive refrain from promoters that their actions are facilitating access to justice for those who do not have the means to pursue it without them.

For now, we think it is prudent to view class action risk as slightly escalated on prior years but as still being largely moderated by the checks and balances on the legal system (including, most importantly, court supervision and the 'loser pays' rule). The position a year from now is likely to depend on how the applications currently before the court in relation to funding models and competing class actions are resolved, and the response to the recommendations ultimately made by the ALRC (which may also depend on the outcome of the next federal election).

> Contacts

Jenny Campbell
Partner
T +61 2 9230 4868
M +61 425 265 415
Jenny.Campbell@allens.com.au

Ross Drinnan
Partner
T +61 2 9230 4931
M +61 410 564 931
Ross.Drinnan@allens.com.au

Belinda Thompson
Partner
T +61 3 9613 8667
M +61 403 346 405
Belinda.Thompson@allens.com.au

Guy Foster
Partner
T +61 2 9230 4798
M +61 410 413 540
Guy.Foster@allens.com.au

Peter O'Donahoo
Partner
T +61 3 9613 8742
M +61 411 596 178
Peter.O'Donahoo@allens.com.au

Michael Ilott
Partner
T +61 7 3334 3234
M +61 414 527 129
Michael.Ilott@allens.com.au

Duncan Travis
Partner
T +61 3 9613 8175
M +61 405 679 708
Duncan.Travis@allens.com.au

Paul Nicols
Partner
T +61 2 9230 4414
M +61 414 223 810
Paul.Nicols@allens.com.au

Kate Austin
Partner
T +61 3 9613 8103
M +61 421 199 084
Kate.Austin@allens.com.au