Unfinished business?

Why the Centro settlement leaves long-debated legal issues unresolved.

BY KEITH BETHLEHEM AND MICHAEL RUSSELL

Most observers, including lawyers and the insurance industry, believed the long-running Centro case would finally answer the questions that have been strenuously debated since shareholder class actions came to the fore.

That was not to be, with a $200 million settlement being approved by the Federal Court on 20 June 2012.

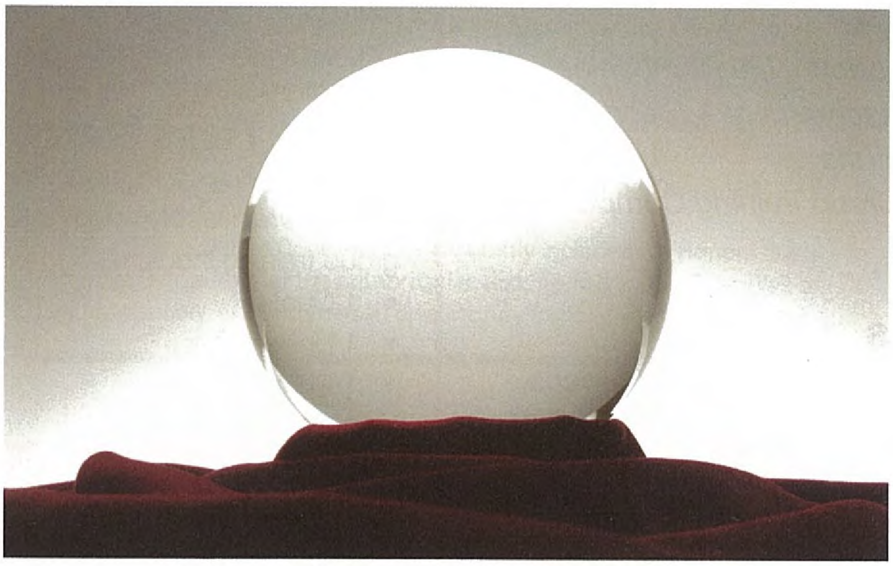
Case background

As shareholder class actions have grown, so has the increasing complexity of the legal issues facing class action defendants and their insurers. The most difficult questions raised by a shareholder class action, principally reliance, causation and damage calculation, have been fiercely debated between plaintiff and defendant lawyers, competing expert economists and insurers (which often carry the ultimate exposure) for the better part of the last decade.

What adds more intrigue and complexity to the issues facing these types of class actions is the string of cases that have settled before judgment. The most notable of those cases was the Aristocrat shareholder class action, which settled in 2008 for reportedly $144.5 million, just weeks before a judgment was expected to be delivered.

With its complex web of facts, multiple parties and a variety of insurers backing the disparate interests, the Centro case had all the hallmarks of a case that would get to judgment and finally provide some clarity on matters that have long caused uncertainty in this area of litigation.

In turn, that certainty would allow insurers to assess reserves, exposures and settlement strategies with more certainty.



“D&O INSURERS MUST CONTINUE TO ASSOCIATE WITH INSUREDS TO LIMIT THE ENDLESS EXPOSURE FACING THE MARKET.”

The Centro case

Proceedings commenced in 2008, when 5000 shareholders in two groups filed representative proceedings against Centro for an estimated $600 million of losses they incurred as a result of the collapse of the Centro share price in late 2007.

The shareholders specifically complained that the company's 2007 accounts understated its current liabilities by more than $3 billion (debts that were incorrectly classified as non-current). This misstatement meant that the company had not properly disclosed to the market that it had at least $3 billion of debt to refinance in the coming 12-month period.

The credit crunch compounded Centro's debt problems. In late 2007, the company disclosed to the ASX that it was struggling to refinance its debt. Centro's share price fell a staggering 76% in one day.

In addition to bringing proceedings against Centro, the proceedings also named Centro's directors and PricewaterhouseCoopers (PwC), its independent auditors for the 2006/07 financial year.

The case went to hearing before Her Honour Justice Michelle Gordon in the Federal Court in March 2012 and was in week 10 when the trial was adjourned for settlement discussions.

On 8 May 2012, the parties announced that the matter had settled for a figure of $200 million. On 20 June 2012, the

Federal Court approved the settlement, which saw the defendants split the amount, with Centro and its directors paying $133 million and PwC paying the remaining $67 million.

The unresolved legal issues

The two main legal issues for shareholder class actions relate to:

- Causation – whether proof of causation can be achieved by the concept of 'a fraud on the market', the share market's inherent reliance on the company's conduct affecting the share price at which shareholders purchased and/or sold their shares. The contrary argument is that each and every shareholder must individually establish that they actually relied on the conduct of the company in deciding to purchase the shares.
- Loss calculation – how shareholder loss is to be calculated in shareholder class actions. A common method involves calculating the level of 'inflation' in the share price as a result of the company's conduct. The objective is to determine the true value of the shares at the time of acquisition, a task that supports stripping out unrelated factors such as market and industry movements. Another method that is often proposed when the shares in question have been sold is a basic 'purchase price less sale price' approach.

Australian courts are yet to provide a guiding decision on which method is to be used. Until such time as a judgment is handed down on the issue, the competing methods will continue to be debated.

What is the impact on insurers?

On the general class-action stage, the settlement preserves the *status quo*. That allows insurers to continue to leverage on the arguments that plaintiffs are required to prove direct reliance. An adverse judgment on reliance would leave insurers more susceptible to increases in both the number and value of class-action awards (noting that an adverse outcome for plaintiffs on the reliance issue would leave insurers with a significantly enhanced position in respect of future class actions).

POSTSCRIPT – THE BRIDGECORP DECISION

The Centro matter almost became notable not only in respect of the shareholder class-action issues, but it came close to providing the forum for a decision in Australia on the Bridgecorp precedent in New Zealand.

If the New Zealand decision in Bridgecorp was followed, it would mean that, in New South Wales at least, under a D&O policy with combined defence costs and loss limit, the policy limit should be preserved for the benefit of paying loss to the plaintiffs under the statutory charge, not the directors' defence costs. The decision potentially renders directors uninsured and personally exposed to large defence costs where claims exceed the policy limit.

An application was brought in the NSW Supreme Court to resolve the Bridgecorp issue in the course of the Centro matter. The motion was immediately referred to a five-judge bench of the Court of Appeal. However, on the day of the hearing, the Court of Appeal was informed that settlement negotiations in the main Centro matter were well advanced and, in the circumstances, the Court of Appeal declined to hear the application.

The judges on the Court of Appeal notably included his Honour Justice Michael Ball, author of the authoritative text, *Kelly & Ball – Principles of Insurance Law*. Another missed opportunity for the insurance industry.

"IN 2008 5000 SHAREHOLDERS FILED PROCEEDINGS AGAINST CENTRO FOR AN ESTIMATED $600 MILLION OF LOSSES."

As to the specifics of the Centro judgment, in which it was held that directors are required to understand the company's financial statements and not merely rely on expert advisers, there may be implications at the front end of the D&O and financial institutions insurance process.

There is scope for greater enquiry at the proposal stage for insurers to ask direct questions about the financial literacy of individual directors in order to assess risk.

That said, however, we do not consider that the Centro judgment creates a significant or unexpected precedent that will expand D&O liability generally by extension, nor do we consider that there will be a material increase in reserves in respect of current or notified claims.

The Centro judgment adopts general principles on directors' liabilities that were always in contemplation. It is almost self-evident that for a director to properly discharge her or his duties, she or he must fully and personally understand the true financial position of the company.

The next white knight?

It could be some time before another shareholder class action will be ready for hearing – even then history shows that it has more chance of settling then it does running to a judgment.

Now more than ever, D&O insurers must continue to associate with their insureds to shape the class-action landscape in Australia in order to limit the exposure currently facing the market. NIBA

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