Article Information

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Continuous disclosure, directors duties and market based causation

On 4 March 2015, the Federal Court of Australia dismissed an action by 77 shareholders against Babcock & Brown Limited (in liquidation) (BBL) and its liquidator. The plaintiffs purchased BBL shares between 21 February 2008 and 13 March 2009. During this time, the share price fell by a notable 98% from $16.76 per share to $0.33 ¢ per share.

The shareholders alleged that BBL had breached its Continuous Disclosure obligations by failing to disclose material information to the market in accordance with the ASX Listing Rules (Listing Rules) and s 674 of the *Corporations Act 2001* (Cth) (Corporations Act).

Background

The shareholders submitted that BBL failed to disclose to the market that:

- Final dividends for 2005-2007 were paid out of capital, contravening s 254Tof the Corporations Act (now repealed).
- The financial reports for 2005, 2006, and 2007 did not provide a true and fair view of its financial position because the reports failed to show that the final dividends had been paid out of capital for 2005-2007 financial years.
- BBL was insolvent on 29 November 2008.
- The 2007 final dividend had been paid out of funds borrowed on the back of an asset revaluation.

The shareholders argued that BBL's failure to disclose this information meant that they acquired their shares at an overvalue and were therefore entitled to recover the difference between what they paid for the shares and what the shares actually would have been worth had the above information been disclosed.

Federal Court Judgement

BBL accepted that the final dividends for 2005, 2006 and 2007 were paid out of capital. However, Justice Perram did not accept the claims of the shareholders about these dividends because he found that their payment was "economically irrelevant to the value of the traded BBL shares".

His Honour further held that whilst there was a technical breach of s 254T, there was no reduction in capital on a consolidated group basis and the breach was a technical accounting error that had no material effect on the financial position of BBL. His Honour found that this information would not be likely to influence those who commonly invest in securities (being those who invest in listed securities generally) had it been disclosed. Accordingly, the incorrect payments of these dividends did not meet the materiality test found in s 677 of the Corporations Act that must be satisfied in order to establish a breach of s 674 of the Corporations Act.

Insolvency

The parties agreed that BBL was insolvent on 29 November 2008. The main issue was whether BBL was 'aware' of its insolvency as at that date and therefore required to disclose that fact under Listing Rule 3.1. The shareholders needed to prove one of the following:

- BBL's insolvency was actually known to the Directors on 29 November 2008
- BBL's insolvency should have become known to the Directors
- An opinion that BBL was insolvent existed and should have become known to the Directors.

Listing Rule 19.12 defines awareness as occurring when 'a director or executive officer…has, or ought reasonably to have, come into possession of the information in the course of the performance of their duties as a director or executive officer of that entity.'

His Honour gave the example of an 'opinion of senior counsel' and explained that if the opinion on insolvency was included in the Board Papers that are distributed to Directors, then the company would be aware of that opinion. The reasonable diligence of the Directors would bring the relevant report to their attention and the company would likely need to disclose that information under Listing Rule 3.1.
In contrast to this, His Honour posited that Listing Rule 3.1 would not be 'engaged where the directors of a company should have, but did not, realise the implications of information of which they were aware.' In other words, the Directors would not be required to disclose information under Listing Rule 3.1 where they should have realised the significance of the information before them (such as the fact of insolvency) but failed to do so. This raised questions around BBL's Board and its competency. Ultimately, His Honour was not persuaded by the shareholder's claims that the Directors were sufficiently experienced to be liable on these grounds.

It was found on a factual basis that on 29 November 2008 the Board was not actually aware of BBL's insolvency, nothing before the Board actually showed BBL was insolvent and there was no opinion on BBL's insolvency in existence of which its Directors ought reasonably have come into possession and of which they should thereby have become aware.

Market-Based Causation

Despite the claim being unsuccessful, His Honour went on to discuss the shareholder's argument of market-based causation. The shareholders argued on the basis of market-based causation that the failure to disclose the relevant information inflated the share price and this indirectly caused loss to the shareholders who had bought shares at an inflated price. BBL argued the narrow view that direct causation, being direct reliance upon the contravening conduct, was required.

His Honour indicated he would have likely found in favour of market based causation should the case have not already failed, and instead reached a point to consider the issue of causation. His Honour noted that he:

"…would accept that a party who acquires shares on a stock exchange can recover compensation for price inflation arising from a failure to disclose material required by s 674 to be disclosed, so long as they are not themselves aware of the non-disclosed material."

The Decision's Significance

This case turned on specific facts. As a result, the above observations it contains about awareness and directors duties will not be applicable in all cases.
While only obiter, the comments of Justice Perram on market-based causation are noteworthy and may indicate a change in the way a Court will treat shareholder actions of this kind. The finer aspects of the theory behind market-based causation, such as market efficiency, were not explored. However, this case is an example of a Courts possible progression away from direct causation in shareholder suits for misleading and deceptive conduct or similar claims. This is a hot topic for litigation funded claims and an area of great change in the law.

Appeal

On 25 March 2015, the shareholders filed an appeal in the Federal Court listing 23 grounds of appeal. Among the grounds of appeal are claims that Justice Perram erred in finding that BBL was not aware of its insolvency.

Piper Alderman will continue to remain abreast of developments in the appeal and in the relevant legal issues over time.

For further information, please contact Partner, David Cornwell.