PiperAlderman

Article Information

Author: Mark Williamson
Service: Capital Markets & Capital Raisings, Class Actions, Corporate & Commercial, Dispute Resolution & Litigation
Sector: Aged Care & Senior Living, Agriculture & Food, Education, Electricity & Gas Regulation, Energy & Resources, Financial Services, Health & Life Sciences, Hospitality, Tourism & Gaming, Infrastructure, IT & Telecommunications, Oil & Gas, Power & Utilities, Real Estate, Renewables, Transport & Logistics

---

Dick Smith Prospectus Litigation

Why has this landmark case seemingly settled for so little and does this show the true value of proper prospectus processes and due diligence regimes?

The Dick Smith IPO may be the poster child for running a high quality IPO due diligence and verification process in order to manage risk in the event that things do not work out for the newly listed company.

Dick Smith was listed in 2013 with a post listing market cap of $520 million; but collapsed into liquidation in 2016 with no prospect of a return to shareholder investors. The subsequent shareholder class actions seem to have failed, with a proposed settlement (subject to court approval) after 48 hearing days into trial with the insurers to pay only a combined total of $25 million. Reportedly, only $6 million of the settlement will be paid to shareholders, with the rest going to costs, and leaving litigation funders out of pocket.

The Dick Smith settlement will deprive Australia's equity capital market, directors and participants of the first Court judgment on the application of Australia's prospectus liability laws and leaves the question of why the case seems to have settled for so little.

The Court is due to consider the settlement on 5 March 2021, but it is likely no official reason will be given to this question.

The application of prospectus liability laws involves applying competing securities law theories of strict causation vs. fraud on the market. It seems that the Dick Smith case will not shed light on this important liability issue as it, presumably, foundered on the difficulties of assessing whether the prospectus was actually misleading and difficulties of piercing the quality of the due diligence defence process undertaken during prospectus preparation.

A high quality and thorough prospectus diligence and verification process is a crucial tool in managing risk for an IPO company to reduce the likelihood of misleading statements in a prospectus. The process is also the basis for due diligence defences that protect directors, bankers, accountants, lawyers and others involved in the offering from the otherwise automatic civil liability consequences of being involved with a misleading IPO.

The Prospectus Liability Claims

The Australian Corporations Act imposes severe liabilities for prospectus misrepresentations against the IPO company, the directors and others involved in the IPO.

Three shareholder class actions against DSHE Holdings Limited (**Dick Smith**), directors and its IPO insurance alleged, amongst other things, that Dick Smith's prospectus contained misleading and deceptive statements which were, in part in relation to Dick Smith's inventory value and the transformation of the business following its 2012 acquisition by Anchorage Capital Partners (**Alleged Misrepresentations**). Dick Smith and directors Michael Potts and Nicholas Abboud, relied on the due diligence defence in the Corporations Act in order to defend against these particular allegations.

The case was expected to be a landmark decision for prospectus-based litigation. It would have been the first judgment in Australia in relation to shareholders ability to recover funds from a company and directors (and their insurers) for misleading

and deceptive statements made in a prospectus, and the second securities class action to go to judgment following *TPT Patrol Pty Ltd as trustee for Amies Superannuation Fund v Myer Holdings Limited* [2019] FCA 1747 (the **Myer case**).

Liability for Misstatements in a Prospectus

Sections 728 and 729 of the *Corporations Act 2001* (Cth) (**Corporations Act**) give a person who has suffered loss or damage *caused* by a misstatement or omission in a disclosure document rights to recover such amount from a broad ambit of people listed in section 729.

In order for a contravention of section 728 to arise, there must have been an offer of securities made under a disclosure document and:

- there must have been a misleading or deceptive statement made in that disclosure document or accompanying application form;
- there must have been an omission from that disclosure document of material required to be disclosed; or
- a new matter must have arisen since lodgement of that disclosure document which would have been required to have been disclosed.

In the Dick Smith class actions, the shareholders' two most significant hurdles to overcome may have been:-

- **Due Diligence Defences:** that a person is not liable for a misleading or deceptive statement made in a disclosure document if they can prove that they made all enquiries that were reasonable in the circumstances, and believed on reasonable grounds that the statement was not misleading or deceptive; and
- **Causation:** that the law in relation to causation would require the shareholders to prove that the class members actually relied on the Alleged Misrepresentations when deciding to invest in Dick Smith's IPO, and that had it not been for those misstatements, the share price would have been lower. However, the plaintiffs argued that the (much easier to establish) "market based causation" approach to causation should be adopted.

Due Diligence Defence

Dick Smith's defence details the due diligence process that was undertaken in preparation of the prospectus. From the pleadings, that process appears to have been at the high quality end of the spectrum of Australian IPO market practice for prospectus due diligence, including:

- establishing a Due Diligence Committee whose role was to ensure that the prospectus content complied with the Corporations Act and that due diligence investigations were all properly undertaken;
- meetings of the Due Diligence Committee;
- allocation of responsibility to appropriate members of the Due Diligence Committee;
- questionnaires being completed by all members of the board and senior management confirming that, to the best of their knowledge, the prospectus contained no deceptive or misleading statements or omissions;
- a verification process in relation to each statement made in the prospectus, and a random review of these verifications undertaken by the solicitors;
- a legal opinion, legal due diligence report and verification report being provided by the solicitors; and
- a prospectus content and due diligence process sign-off, accounting due diligence report, and investigating accountants' report on historical and forecast financial information.

The Dick Smith class actions provided a rare chance for a Court to assess the due diligence process. Dick Smith needed to prove in its defence that:

- the process undertaken resulted in all enquiries being made which were reasonable in the circumstances; and
- the potentially liable persons reasonably believed that the Alleged Misrepresentations were not misleading or deceptive.

Causation

The Dick Smith case was widely expected to see the Court apply a market-based causation approach to determining prospectus liability, following Beach J's decision in the Myer case.

In the Myer case, Beach J accepted the concept of market-based causation in Australia, being a means of connecting the company's breach with the loss suffered by the shareholders. A significant aspect of the doctrine is that a shareholder does not need to demonstrate that they were aware of and relied on a misrepresentation. Rather, shareholders claim that because of a company's breach, shareholders generally acquired the company's shares at an inflated price, causing shareholders a loss even if the particular shareholder had not read the disclosure. Whilst the Myer case did not concern a

prospectus, but rather representations in relation to company earnings guidance and continuous disclosure breaches, it affirmed market based causation and set out the steps to demonstrating it in that case. Those steps are:

1. non-disclosure of material information by the company to the market;
2. the listed price for the securities being inflated by such non-disclosure; and
3. investors purchasing the securities “on market” at the inflated price.

If Dick Smith does in fact settle as now proposed, we will have to wait longer for a court to deliver judgment on whether the same “fraud on the market” causation theory also applies to prospectus liability.

Conclusion

The settlement of the Dick Smith case should be seen as an indication of the importance of a thorough and high quality prospectus and due diligence process for any IPO in Australia.

In recent years, some Australian IPOs have involved prospectus and diligence processes that have departed from the high water mark processes of the past. Departures have included cutting out some of the key steps or cosmetically following the steps but without actually following a thorough work program. No doubt the main reason for this departure is pressure to minimise IPO costs; but due to the lack of final Court judgments in IPO liability cases there has also been a lessening of concerns that Australia’s prospectus liability regime will actually bite IPO participants.

The likely advance of the “fraud on the market” causation theory to prospectus liability makes it even more important for IPO participants to ensure only high quality and thorough prospectus and due diligence regimes are followed and taken seriously as risk management processes.