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Uncovering the facts with the Ferrier Hodgson Forensics team

Fraud on the Market – what role will experts play?

In the last five years Australia has seen an increasing number of shareholder class actions in pursuit of companies that allegedly failed to properly inform the market. Ion, Downer EDI, Telstra, Aristocrat and Multiplex have all faced this prospect.

With these cases has come interest in the US concept of "Fraud on the Market" – a theory that permits claimants to sue for damages without having to individually establish specific knowledge of, and reliance on, the company's misrepresentations in making a decision to buy or sell.

Australian law does not recognise a fraud on the market theory as such, but it does have long-standing legal principles that have a similar effect. For example, under the continuous disclosure regime, shareholders may seek to recover compensation caused by failure to disclose material information. Individual reliance is not an element of the cause of action.

Regardless of whether this doctrine becomes part of legislation, our existing legal principles mean that many of the forensic issues associated with the concept in the US are already applicable here.

In this month's Forensics@Ferriers we consider the related concept of the "event study" and consider who has the expertise to help parties involved in the often treacherous waters of shareholder class actions.

Let's start with the issue of what influences shareholders in deciding whether and when to purchase shares in a particular company. One key decider is the broad range of publicly available information. As the sophistication of shareholders varies widely, so does the extent to which this information plays a part in millions of daily individual investment decisions. Even when disclosure to the market is both timely and accurate, it is unlikely that all investors react in the same manner or understand the information with equal depth.

Assuming failure to disclose timely and accurate information can be proven, and that this led to someone paying an inflated price for shares, can it be said that all shareholders suffered equally? To what extent did each investor actually rely on the information in making their investment, or divestment, decision? In cases where material information has been withheld, how do shareholders, either individually or collectively, demonstrate that they have suffered a loss? Even if the shareholder never saw the information, do they make a loss simply because they bought shares in a misinformed, inflated market?

These are some of the central issues in the fraud on the market concept.

The recent CAMAC discussion paper on shareholder claims against insolvent companies provides a pertinent summary[1]:

> *A possible way to facilitate proof of aggrieved investor claims may be a statutory amendment to introduce a 'fraud on the market' approach. This would assist shareholder litigation against companies by establishing a rebuttable presumption of reliance on misleading or deceptive information from the company. It would overcome the need to prove reliance.*

Issues for experts in fraud on the market cases

To date, little case guidance exists here on the acceptance of the fraud on the market approach. We are aware of only three cases[2] where an event study approach has been considered by the Court.

In cases concerning misrepresentation or non-disclosure, the impact of the relevant information on share price needs to be measured or estimated. The event study approach is an established method in the US of measuring this impact, in terms of how the market would have reacted if the same announcement had been made in a timely manner. It involves identifying what part of a change in price on the day of disclosure is a reaction to the announcement, and what can be explained by other factors, such as movement of the market as a whole.

The growth in the number of shareholder class actions in Australia means we are likely to see more frequent use of the event study method here. Although the approach has gained acceptance, it is certainly not without pitfalls, and review of the many US cases of this type highlights the inherent difficulties in assessing the merits of the loss claimed in such circumstances.

We observe that these issues, and the way in which experts might approach them, are as follows:

The event

There must be an identifiable 'news event' in which the market is informed of the previously non-disclosed information. These are typically 'bad' news stories, such as a profit downgrade or a major balance-sheet revision.

Announcements of this type don't just suddenly happen. There is a chain of events leading up to each announcement involving the production, review and refinement of financial and accounting information by employees, directors and others. These are potential sources of evidence as to how the information came to be known, to whom it was known, and how and when it was disclosed to the market.

This information can be identified through an independent forensic investigation designed to review and reconstruct accounting and transactional data, business records, internal forecasts and email communications.

Classes of shareholder

Investors are not all equal; those who purchased shares before any wrong-doing will be ineligible. The initial task of identifying and qualifying classes of shareholder, and their trading activity, is best done through access to transactional share trading data.

This leads on to consideration of what amount, if any, has been lost by each shareholder, or class. In many cases, the impact of the news event has been expressed in terms of a loss of value. In quantifying loss, the question is: what is meant by 'value'? And is the use of market capitalisation the appropriate basis of value?

This is an area where expert accountants, valuers, economists and stockbrokers may each have their own views.

1 Australian Government Corporations and Markets Advisory Committee; *Shareholder Claims Against Insolvent Companies, Implications of the Sons of Gwalia decision*, Discussion Paper, September 2007.

2 Judgment was handed down in the case of Kim Riley in his capacity as Trustee of the Ker Trust v Jubilee Mines NL [2006] WASC 199. This case, however, is distinguishable; it was not a class action, and it centres on the alleged failure to disclose 'good news'. Notwithstanding, it provides interesting reading on the issues common to actions relating to alleged failure to disclose.

Event studies were also used in Taylor v Telstra Corporation Ltd [2007] FCA 2008, which also makes reference to the Dorajay Pty Ltd v Aristocrat Leisure Limited case.

Australia's share market

A very clear distinction between the US and Australian share markets is our relative lack of depth. We are likely to see that in many cases the lack of comparable companies for the purpose of testing the impact of news events on the share price of those companies may become one issue which experts need to carefully address. Time will tell whether Australian courts are prepared to accept evidence based upon the experience of US-listed companies.

Which expert?

The event study is, in the US at least, typically seen as lying squarely within the realm of expert economists. We observe that in a number of recent Australian cases, the opinions of US economists have been sought. This may point to a lack of Australian expertise, or at least expertise in providing testimony in Court.

The supplementation of this expertise with local financial, share market or accounting expertise may be warranted to ensure acceptance of the overseas expert's opinions.

Accounting and financial issues are central

In this burgeoning field, where the law and the use of experts is still in its infancy, we can expect to see substantial differences in the approaches being adopted by parties on the path to litigation.

Central to most claims of this type, however, are financial and accounting issues [see table]. Announcements relating to financial position and solvency, revenue and profit recognition, recurring vs. non-recurring profits and earnings forecasts, have been pivotal to most cases so far. Assessing the materiality of the transactions which are the subject of the announcement is also a common focus.

Selected current class actions involving allegations of non-disclosure

Action	Central claim	Plaintiffs	Status
Ion Ltd	■ That information concerning the company's real financial position was withheld from the market. Ion entered administration in Dec 2004 with debts of $700m. ■ Claim up to $55m.	Shareholders purchasing shares between 20 Oct 03 & 7 Dec 04	Proceedings not commenced. Proofs being adjudicated on by Administrator
Downer EDI Ltd	■ That Downer knew, or ought to have known, at a time earlier than August 2006, that amounts previously recognised as revenue would need to be expensed, and net profit after tax was not going to increase by 20% from the previous year. ■ Claim up to $12m.	Shareholders purchasing shares between 23 Feb 06 and 8 Aug 06	Proceedings being prepared
Telstra	■ That Telstra gave a private briefing to the then Prime Minister, John Howard, in August 2005. That this information was material to the share price and should have been disclosed to the market at the same time – not in September 2005.	Shareholders purchasing shares between 11 Aug 05 and 6 Sept 05	Federal Court approved a $5m settlement in December 2007
Aristocrat	■ That a series of profit results and announcements were made to the market that misinformed the market, for example the inclusion in profit of revenue recognised in advance of receipt of payment. ■ A profit downgrade on 7 February 2003 led to a fall in market capitalisation of approximately $1 billion. ■ Claim up to $190m.	Shareholders purchasing shares between 19 Feb 02 and 26 May 03	Pending judgment

From Ferrier Hodgson's viewpoint, these key issues lie clearly within the skill sets of our forensic accountants, with extensive experience in identifying and assessing accounting evidence on behalf of both plaintiffs and defendants in major commercial disputes.

As one example of our work in this area, in the recent Aristocrat case, Greg Meredith and his team from Ferrier Hodgson's Melbourne office prepared the expert accounting evidence on which the plaintiffs based their case. A US economist then prepared an event study based on the accounting evidence to quantify the plaintiffs' loss.

Conclusion

In our experience to date, these cases are typified by a mass of transactional, accounting and business data, something we are well equipped to deal with.

Regardless of whether the fraud on the market doctrine becomes part of Australian law, recent events suggest we can expect to see a continuation of shareholder class actions against both solvent and insolvent companies. Both class action firms and advisors to major corporations (or their liquidators) would be well advised to canvass a range of expert views from a number of disciplines – economists, accountants, valuers or stockbrokers – at an early stage of the case, to ensure that all issues and arguments are appropriately considered. Having an experienced team of expert forensic accountants on board will assist in ensuring key data is identified, analysed and understood.

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