

A STEP FORWARD FOR MARKET BASED CAUSATION?

22 April 2016 | Australia, Brisbane, Melbourne, Perth, Sydney
Legal Briefings - By **Damian Grave** and **Helen Mould**

The issue of how to prove causation has been the subject of significant debate in [Australian securities class actions](#) involving alleged contraventions of the Corporations Act or the ASIC Act arising from statements made by corporations to the ASX.

- To recover damages in these types of claims a shareholder plaintiff must prove that the company's contravention caused their loss - a concept known as causation.
- In Australia, courts have traditionally held that where a misrepresentation has induced a transaction (including a share transaction) the plaintiff must show that they relied on the misrepresentation in order to establish causation.
- On 20 April 2016, In the matter of *HIH Insurance Limited (in liquidation) & Ors*[2016] NSWSC 482, a single judge of the NSW Supreme Court held that the plaintiffs could establish causation by showing that they purchased shares on the market at an inflated price.
- The court held that the plaintiffs did not need to establish that they relied on the misrepresentations in order to recover loss (direct reliance). It was enough that the market relied on, and was misled by, the misrepresentations (indirect market based causation).
- This is the first judgment in Australia where a court has accepted an indirect market based theory of causation. Although the proceeding is not a class action, the judgment will be relevant to the issues considered in [securities class actions](#).

THE DECISION

Background

The plaintiffs in this case were investors who acquired shares in HIH Insurance Limited (**HIH**) between 26 October 1998 and 15 March 2001 (the last day that HIH traded on the ASX).

The plaintiffs claimed that during 1999 and 2000 HIH released financial results that contained misleading or deceptive representations. They claimed that by publishing the results and releasing them, HIH contravened s52 of the *Trade Practices Act 1974*(C'th) and ss 995 and 999 of the Corporations Law. HIH admitted the allegations.

The plaintiffs argued that at the time they purchased their HIH securities, the price at which the securities were trading was inflated by virtue of the misleading financial results.

When HIH went into liquidation, investors lodged proofs of debt on the basis that they had suffered loss and damage by reason of having paid more for their HIH shares than they would otherwise have paid had the market price not been inflated.

The liquidators and scheme administrators did not admit their proofs. The plaintiffs appealed to the NSW Supreme Court seeking that their proofs be admitted.

CAUSATION

In shareholder claims based upon causes of action under the Corporations Act 2001 (C'th), the loss or damage incurred by the shareholder must “result from” (in the case of continuous disclosure) or “by” (in the case of misleading conduct) the contravening conduct.¹

In this decision, which involved allegations of misleading or deceptive conduct only, the court examined the meaning of the word “by” in the former Trade Practices Act and the Corporations Law. In accordance with the High Court’s decision in *Wardley Australia Ltd v Western Australia*, the judgment states that the word “by” expresses the notion of causation without elucidating it.²

In Australia, courts have traditionally held that where a misrepresentation has induced a transaction (including a share transaction) the plaintiff must show that they relied on the misrepresentation in order to establish causation.

The plaintiffs in this case, however, did not seek to argue that they read or directly relied on the financial results containing the misleading representations.

Instead the plaintiffs argued that they acquired their HIH securities in a market regulated by the ASX and the Corporations Law (at that time) and that this market was distorted by the misrepresentations.

In deciding whether the plaintiffs' proofs be admitted in the liquidation, the court had to determine whether the plaintiffs were entitled to claim damages on the basis of "indirect causation", without proving direct reliance on the contravening conduct.

The court held that indirect (market based) causation was adequate to establish compensable loss. In doing so, the court distinguished the longstanding authorities supporting reliance, *Digi-Tech (Aust) Ltd v Brand*³ and *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd*⁴ and stated that:

*"[W]hile the contravening conduct did not directly mislead the plaintiffs, it deceived the market (constituted by investors, informed by analysts and advisors) in which the shares traded and in which the plaintiffs acquired their shares. Investors who acquire shares on the share market do so at the market price. In that way, they are induced to enter the transaction...on the terms on which they do by the state of the market. Investors who acquire shares on the ASX may reasonably assume that the market reflects an informed appreciation of a company's position and prospects, based on proper disclosure."*⁵

Justice Brereton also stated:

*"I do not see how the absence of direct reliance by the plaintiffs on the overstated accounts denies that the publication of those accounts caused them loss, if they purchased shares at a price set by a market which was inflated by the contravening conduct: the contravening conduct caused the market on which the shares traded to be distorted, which in turn caused loss to investors who acquired the shares in the market at the distorted price. In the absence of any suggestion that any of the plaintiffs knew the truth about, or were indifferent to, the contravening conduct, but proceeded to buy the shares nevertheless, I conclude that "indirect causation" is available and direct reliance need not be established."*⁶

In deciding that indirect causation was available, Justice Brereton emphasised that the plaintiff needed to establish *"by evidence and/or inference, that the contravening conduct distorted the market price so as to cause the shares to trade at an inflated price."*⁷

LOSS

Justice Brereton also considered how the plaintiffs' loss and damage stemming from the contraventions was measured and proved.

(a) Loss methodology

The plaintiffs alleged that the defendants' contravening conduct caused them to pay an inflated price for the shares they purchased.

Consistently with other cases, the judgment draws a distinction between this inflation-based loss measure (wherein it is said loss is measured by the difference between the price paid and the price the plaintiffs would have paid had the contravening conduct not occurred, but all other factors remained equal) and a 'true value'-based measure (wherein loss would be measured by the delta between price paid and the 'true value' of the shares).

The judgment identifies two other possible measures of loss:

- it is noted that the plaintiffs did not allege a 'no transaction' case (ie they did not allege that the contravening conduct caused them to acquire shares they would otherwise not have acquired),
- in the course of closing submissions, the plaintiffs sought to advance a 'left in hand' measure of loss (ie claiming the difference between the price paid for the shares and the value of the shares as currently held). However, Justice Brereton considered that this arose too late, and moreover was inconsistent with the causation theory underpinning the plaintiffs' case (ie that they suffered damage by paying a price higher than they would otherwise have paid, not that they would not have acquired the shares at all).

None of the above methodologies is a novel measure of loss; indeed, in securities class actions it is typical for lead plaintiff shareholders to allege various of these loss measures as alternatives. The variety of alternative loss measures reflects the uncertainty that exists in the absence of much judicial authority in this area, but it also reflects the fact that measurement of loss is a highly fact-driven inquiry. In a specific scenario, a range of approaches may be brought to bear, and those approaches may have markedly different consequences. This means that:

- even if the present uncertainty about the applicable legal principles begins to resolve, plaintiffs, defendants and other stakeholders (such as funders and insurers) are likely to continue to view a range of possible loss measures as indicators of a spectrum of possible outcomes. Relatively small differences in the possible measures of loss for an individual group member may translate into substantial differences when the whole of the class is taken into account,
- when a shareholder class action does proceed to judgment, the judgment will resolve only the claims of the lead plaintiffs (and sample group members, if they exist). Thus, a judgment is unlikely to quantify completely, or with certainty, the extent of loss across the class. To the extent the judgment is anchored in the particular circumstances of the lead plaintiff (or sample group members), it may not yield benchmarks that facilitate, conclusively, quantification across the class.

(b) Proving loss

The parties in HIH led expert evidence on the level of loss occasioned by HIH's misleading accounts. The plaintiff's expert prepared a regression model based on the price to book value of comparator Australian insurance businesses and applied this to derive a value for HIH shares. The judge preferred an approach which assessed the impact of the contravening conduct as represented by the difference between the price at which HIH shares actually traded on the market and a hypothetical price derived by applying the price to book value at which they traded to a notional book (adjusted to take account of the errors in the accounts).

The case is not a continuous disclosure case, and the expert evidence evaluated by the court in this case is not 'event study evidence' (being a particular form of economic analysis directed at isolating, through analysis of statistically significant share price returns, the likely share price impact of a counterfactual disclosure, ie the disclosure which it is alleged ought to have been made). Consequently, this judgment does not provide much detail about the receptiveness of courts to different types of expert evidence in the shareholder class action context.

HOW DOES THIS DECISION IMPACT SECURITIES CLASS ACTIONS IN AUSTRALIA?

While the decision of Justice Brereton is the first of its kind, and may encourage proponents of market based shareholder class actions, it is unlikely to be the last word on this issue in the Australian context.

It has been long anticipated, including by the courts,⁸ that when a decision on this issue was forthcoming, it would likely move on appeal to the High Court. Given its liquidation context, it may be that it is not the HIH decision that finds its way to the High Court but another case. Plaintiffs and defendants alike will wait to see if Justice Brereton's conclusion and reasoning are followed by other courts.

In the interim, questions will remain as to whether indirect market based causation supports one of the key objectives of the continuous disclosure regime, namely, to encourage investors to read and consider corporate disclosures.

The full judgment is available [here](#).

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This article was written by [Helen Mould](#), Executive Counsel and Leah Watterson, Senior Associate, Melbourne.

ENDNOTES

1. See further Grave, Watterson and Mould *Causation, loss and damage: Challenges for the new shareholder class action* (2009) 27 C&SLJ 483.
2. In the matter of *HHH (in liquidation) & Ors* [2016] NSWSC 482 at [37] referring to *Wardley v Western Australia* [1992] HCA 55.
3. (2004) 62 IPR 184.
4. (2008) 252 ALR 659.
5. In the matter of *HHH (in liquidation) & Ors* [2016] NSWSC 482 at [73].
6. In the matter of *HHH (in liquidation) & Ors* [2016] NSWSC 482 at [77].
7. In the matter of *HHH (in liquidation) & Ors* [2016] NSWSC 482 at [78].
8. In *P Dawson Nominees Pty Ltd v Brookfield Multiplex Limited (No 4)* [2010] FCA 1029 at [16] Finkelstein J stated: "the relative novelty and legal importance of the issues suggests that even were the applicants to succeed at trial, the matter would likely go on appeal, perhaps to the High Court if special leave is obtained."

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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