JUDICIAL RECOGNITION OF INDIRECT CAUSATION AND SHAREHOLDER CLASS ACTIONS

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Introduction

In shareholder class actions alleging misleading corporate conduct, causation is always a key issue. Traditionally, Australian courts have held that each shareholder must demonstrate that they were aware of, and directly relied on, the corporate misconduct in question. However, in recent cases the concept of indirect causation has been held as arguable, although it has never been authoritatively adopted. Indirect causation was taken one step further in the decision of *In the matter of HIH Insurance Ltd (in liq)*,[1] where the Supreme Court of New South Wales recognised and applied this legal principle in a shareholder claim that was not a class action. Brereton J held that shareholders rely on the share price as an accurate reflection of share value. Accordingly, when corporate misconduct inflates the share price, the corporation indirectly causes shareholders to suffer loss. *HIH Insurance* is a milestone case as it increases the likelihood of shareholder class actions being commenced due to the recognition of indirect causation, thus making this central requirement for success easier to prove.

Background

Most Australian shareholder class actions have relied on alleged contraventions of the continuous disclosure regime in Ch 6CA of the *Corporations Act 2001* (Cth), which contains "financial services civil penalty provisions" or the prohibitions on misleading or deceptive conduct – most notably, s 1041H of the *Corporations Act* and s 12DA of the *Australian Securities and Investments Commission Act 2001* (Cth) (**ASIC Act**).[2]

Contravention of these provisions gives rise to an ability to seek damages or compensation. The statutory wording of "resulted from", "by" and "because" that is used in the relevant provisions[3] has been interpreted as necessitating proof of causation.[4]

Direct reliance is the traditional or conventional test for causation and in the shareholder class action context would require each group member to prove that they relied on the misleading disclosure in deciding to buy securities.[5] However, some form of indirect causation has been pleaded in many shareholder class actions.[6] Indeed it was pleaded, briefed and argued in the Aristocrat shareholder class action that was commenced in 2004; however, Aristocrat – like all other shareholder class actions – settled. Consequently, there was no authoritative judgment on the issue of whether indirect causation could satisfy the statutory causation requirement.[7] In 2015, indirect causation was found to be arguable for the purpose of an interlocutory pleading dispute in a shareholder class action by the

[1] *In the matter of HIH Insurance Ltd (in liq)* (2016) 113 ACSR 318.

[2] M Legg, "Shareholder Class Actions in Australia – The Perfect Storm?" (2008) 31(3) UNSWLJ 669, 675-687; M Legg, "Shareholder Protection and Class Actions" (*Supreme Court of New South Wales Corporate Law Conference*, Banco Court, Sydney, 29 July 2014).

[3] *Corporations Act 2001* (Cth) ss 1041I ("by"), 1317HA(1) ("resulted from"), 1325(2) ("because"); *Australian Securities and Investments Commission Act 2001* (Cth) s 12GF ("by").

[4] *Wardley Australia Ltd v Western Australia* (1992) 175 CLR 514, 525 (Mason CJ).

[5] J Beach, "Class Actions: Some Causation Questions" (2011) 85 ALJ 579, 584.

[6] See eg *P Dawson Nominees Pty Ltd v Brookfield Multiplex Ltd (No 4)* [2010] FCA 1029 [15]-[17]; *Hobbs Anderson Investments Pty Ltd v Oz Minerals Ltd* [2011] FCA 801 [9]-[10]; *Pathway Investments Pty Ltd v National Australia Bank Ltd (No 3)* [2012] VSC 625 [11]-[12]; *Camping Warehouse Australia Pty Ltd v Downer EDI Ltd* [2014] VSC 357 [35]-[61].

[7] M Legg, "The Aristocrat Leisure Ltd Shareholder Class Action Settlement" (2009) 37 ABLR 399.

Full Federal Court,[8] although the application of indirect causation to a shareholder class action after a final hearing remained elusive. Indirect causation finally received consideration in the non-class action context in *HIH Insurance*.

The HIH Insurance shareholder claim

The plaintiffs acquired HIH shares between 26 October 1998 and 15 March 2001. The plaintiffs contended, and the defendants admitted, that HIH had released misleading and deceptive financial results during this period. In releasing these results, HIH acted in contravention of s 52 of the *Trade Practices Act 1974* (Cth) and ss 995 and/or 999 of the *Corporations Law* (Cth). Section 52 and s 995 both state that a person must not engage in misleading or deceptive conduct, while s 999 states a person must not make a false or misleading statement in relation to securities. Today's equivalent sections are s 1041H of the *Corporations Act*, s 12DA of the ASIC Act and s 18 of the *Australian Consumer Law*.

The financial results overstated HIH's operating profit and net assets. Consequently, the plaintiffs claimed that at the time they purchased HIH shares, the price at which the shares were trading was inflated due to the misleading financial results. Importantly, the plaintiffs did not contend that they had read, or directly relied upon, the financial results reports. Rather, they argued that they acquired these shares in a market that had been distorted by the misrepresentations, so that HIH shares traded at inflated prices. The plaintiffs claimed they suffered loss and damage by reason of having paid more for the shares than they would otherwise have paid had the market price not been inflated.

When HIH went into liquidation, the plaintiffs lodged proofs of debt to this effect. The liquidators and scheme administrators did not admit these proofs. Consequently, the plaintiffs appealed to the New South Wales Supreme Court seeking that their proofs be admitted.

Brereton J identified two key issues with regards to whether the plaintiffs could claim damages without establishing direct reliance on the misleading financial results. First, whether the plaintiffs were entitled to claim damages on the basis of "indirect causation". Secondly, if the plaintiffs were so entitled, how would the court determine if the contravening conduct had indirectly caused damages and how could the court quantify those damages.

Indirect causation is sufficient

Arguably, the most significant part of the *HIH Insurance* judgment was the finding that indirect causation is available to shareholder plaintiffs claiming misleading and deceptive corporate conduct, and that direct reliance need not be established. In reaching this conclusion, the Court first established that the ultimate question posed by the relevant statutory causes of action is one of causation, not reliance. This is because s 82(1) of the *Trade Practices Act* and s 1005(1) of the *Corporations Law* simply require that a plaintiff suffers loss or damage "by" the contravening corporate conduct. The term "by" expresses a need for causation without defining this concept further,[9] essentially signifying that the concept has a broad ambit requiring no more than that the contravening conduct materially contributed to the loss or damage. Brereton J stated: "If causation – 'by conduct of' – can otherwise be established, it cannot matter that reliance is not established."[10]

The judgment supported this position by examining three groups of case law. First, Brereton J drew attention to cases that stand as authority for the principle that direct reliance is not the only means of satisfying causation. In the High Court case of *Campbell v Backoffice Investments Pty Ltd*, Gummow, Hayne, Heydon and Kiefel JJ stated that reliance is not a substitute for causation.[11]

In addition, particular emphasis was placed upon *Janssen-Cilag Pty Ltd v Pfizer Pty Ltd*,[12] where the Federal Court held that under s 82 of the *Trade Practices Act* plaintiffs may claim compensation

[8] *Caason Investments Pty Ltd v Cao* (2015) 236 FCR 322.

[9] *Wardley Australia Ltd v Western Australia* (1992) 175 CLR 514, 525.

[10] *In the matter of HIH Insurance Ltd (in liq)* (2016) 113 ACSR 318 [42].

[11] *Campbell v Backoffice Investments Pty Ltd* (2009) 238 CLR 304, 351.

[12] *Janssen-Cilag Pty Ltd v Pfizer Pty Ltd* (1992) 37 FCR 526

where the contravener's conduct caused other persons to act in a way that led to loss or damage to the plaintiff. In this case, the plaintiff and defendant were rival pharmaceutical companies competing for the same customer base. Causation was established by proving that the defendant misled the customer base, which caused the customers to purchase more of the defendant's product and less of the plaintiff's product. The plaintiff was not misled, but suffered loss as a result of the defendant's misleading conduct. It is important to note that in *Janssen-Cilag* the Court found that the contravening conduct had misled customers rather than the market as a whole.

Secondly, Brereton J considered recent cases that endorsed the concept of indirect causation in obiter dicta. In 2015, the Full Federal Court considered that indirect causation was arguable in shareholder actions, in the context of an interlocutory application in *Caason Investments Pty Ltd v Cao*.[13] In the same year, Perram J commented in obiter in *Grant-Taylor v Babcock & Brown Ltd (in liq)*[14] that an investor could recover damages against a company who had failed to comply with its continuous disclosure obligations without proving a direct causal link between the non-disclosure and their loss. This decision was recently considered by the Full Federal Court on appeal, but the Court declined to comment on the issue of indirect causation as it was not necessary to resolve the appeal.

Finally, Brereton J distinguished two New South Wales Court of Appeal cases that held that direct reliance is necessary to prove causation, namely *Digi-Tech (Australia) v Brand*[15] and *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd*.[16] His Honour noted that these cases involved different factual scenarios to *HIH Insurance*. Neither considered "market-based causation", and neither was concerned with a situation where the alternatives were transactions at a lower or higher price in which the contravening conduct had the necessary consequence of prompting the higher price.

Rather, both *Digi-tech* and *Ingot* were concerned with a scenario in which the alternatives were transaction or no transaction. In *Digi-tech*, the defendant produced misleading forecasts that provided a sufficiently high valuation of the products to allow the investment scheme to go ahead, and investors suffered loss.[17] Likewise, the plaintiffs in *Ingot* argued that but for the defendant's misleading conduct the defendant would not have issued a converting note, and the plaintiffs would not have invested in this note to their detriment.[18] In addition, the policy of *Digi-Tech* and *Ingot* is to deny damages where the contravening conduct did not mislead anyone. This is distinct from the indirect causation argument in the present case that HIH's conduct misled the market.

On this basis, Brereton J held:

> If the contravening conduct deceived the market to produce a market price which reflected a misapprehension of HIH's financial position (which is a factual question to be resolved in conjunction with the quantification of damages), then it had the effect of setting the market at a higher level – and the price the plaintiffs paid greater – than would otherwise have been the case. In such circumstances, plaintiffs who decided – entirely oblivious to the contravening conduct – to acquire shares in HIH, were inevitably exposed to loss. Moreover, they were members of the class who would obviously be affected by the contravening conduct.[19]

His Honour concluded that shareholders are able to recover losses they have suffered if four conditions are met. First, a company must release misleading results to the market. Secondly, the market must be deceived into a misapprehension that the company is trading more profitably than it

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[13] *Caason Investments Pty Ltd v Cao* (2015) 236 FCR 322.

[14] *Grant-Taylor v Babcock & Brown Ltd (in liq)* (2016) 330 ALR 642.

[15] *Digi-Tech (Australia) v Brand* (2004) 62 IPR 184.

[16] *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* (2008) 73 NSWLR 653.

[17] *Digi-Tech (Australia) v Brand* (2004) 62 IPR 184 [158].

[18] *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* (2008) 73 NSWLR 653 [601].

[19] *In the matter of HIH Insurance Ltd (in liq)* (2016) 113 ACSR 318 [74].

really is. Thirdly, the shares of the company must trade at an inflated price. Fourthly, investors pay the inflated price for the shares and thereby suffer loss.[20]

Quantifying the plaintiffs' damages

The Court then turned to the second issue, that is, how to determine if the contravening conduct had indirectly caused damages, and how to quantify those damages. Brereton J found that the quantum of damages resulting from the plaintiffs' claim should be the difference between the price the shares were trading at and the price they would have traded at if the contravening conduct had not occurred but all other factors had remained constant.[21] This case was not a simple "no transaction" case, in which the contravening conduct was said to have caused the plaintiffs to have acquired shares that they otherwise would not have acquired. Rather, the measure of the plaintiffs' damages must reflect the plaintiffs' claim that the contravening conduct caused them to pay an inflated price for shares they would have acquired in any event.[22]

The plaintiffs' expert sought to quantify the impact of the contravening conduct on the HIH share price by providing the Court with a conditional relative valuation model. This model involved a regression analysis of the market price of shares in comparable insurance companies and applied this to derive a value for HIH shares. By the conclusion of submissions, the defendants largely agreed with the plaintiffs' methodology.

However, Brereton J rejected this model, noting it had a number of problems. First, the methodology produced a constant "flat line" price, whereas in fact the market price fluctuated on a daily basis. Secondly, the model sought to infer a hypothetical value for an HIH share, using other insurance companies as comparators, and disregarding the actual performance of HIH shares. In addition, the model produced a hypothetical price that was in fact higher than the actual HIH market price during one of the relevant time periods.[23] Instead of employing the plaintiff's proposed loss methodology, his Honour provided his own method of quantifying the plaintiffs' damages:

> [T]he better approach to evaluating the impact of the contravening conduct on the share price is to identify the difference between the price at which HIH shares actually traded on the market, and the hypothetical price achieved by applying the price to book value at which they actually traded to an adjusted book.[24]

As a result, the plaintiffs who acquired their HIH shares during, and after, the release of the misleading financial results were awarded damages equivalent to this difference.

Assuming an efficient market

In setting the test for determining whether the contravening conduct in fact influenced the market price, Brereton J stated:

> [I]f the price at which the shares actually traded exceeds that at which, absent the contravening conduct, they would have traded, then indirect causation in fact will be established.[25]

It seems implicit in this statement that his Honour assumed the contravening conduct was able to influence the HIH share price. This begs the question, how exactly does the contravening conduct do so?

Essentially, to satisfy this Court's indirect causation test the conduct must be proven to have misled the market. Indeed, as Brereton J noted, this is what distinguished the present case from *Digi-tech* and *Ingot*. To determine if the market was misled, it is necessary to determine if the shares were subject to an efficient market, which is shorthand for a market that immediately incorporates

[20] *In the matter of HIH Insurance Ltd (in liq)* (2016) 113 ACSR 318 [75].

[21] *In the matter of HIH Insurance Ltd (in liq)* (2016) 113 ACSR 318 [79].

[22] *In the matter of HIH Insurance Ltd (in liq)* (2016) 113 ACSR 318 [79].

[23] *In the matter of HIH Insurance Ltd (in liq)* (2016) 113 ACSR 318 [97]-[98].

[24] *In the matter of HIH Insurance Ltd (in liq)* (2016) 113 ACSR 318 [126].

[25] *In the matter of HIH Insurance Ltd (in liq)* (2016) 113 ACSR 318 [80].

publicly available information into the share price so that the price is reflective of that information. This is because the indirect causation principle relies on "assumptions of an efficient market and rational investors making decisions based on the integrity of the share price" as links in the causal chain.[26]

The Court appeared to recognise that an efficient market is a necessary precondition for a successful indirect causation claim. His Honour noted that a well-developed market reflects all publicly available information, including any misrepresentations, which is in turn reflected in the price of shares traded on that market.[27] Yet Brereton J never directly addressed whether HIH shares were subject to such a market, simply stating:

> Intuitively, it is a reasonable and logical hypothesis that the ordinary and natural consequence of an overstatement to the market of a listed company's financial performance would be to inflate its share price.[28]

Ramifications

HIH Insurance is the first Australian case to determine that indirect causation is sufficient to satisfy the causative element required in shareholder claims of corporate misleading and deceptive conduct. As a result, its ramifications are significant and manifold.

This decision will provide plaintiffs with more opportunities to make a successful claim in securities cases involving alleged corporate contraventions. Proof of causation is a mandatory requirement for a successful claim based on the statutory misleading or deceptive conduct causes of action. Failure to prove causation means that a shareholder's claim fails.[29] With the advent of *HIH Insurance*, shareholder plaintiffs are now required to satisfy a lower threshold for causation – that of demonstrating that the misleading conduct caused an inflated share price to the detriment of the plaintiff.

In addition, this decision's endorsement of indirect causation may well apply equally to the continuous disclosure regime of the *Corporations Act*, which requires causation through the words "resulted from". However, the appropriate causation test under this regime will be determined by reference to the specific wording, context and purpose of the relevant legislation. Consequently, it cannot be said definitively whether courts will apply indirect causation to the regime.

While *HIH Insurance* is not a class action proceeding, the Court's application of indirect causation will most likely be transferred to that context. Brereton J's reasoning seems to suggest this when his Honour commented that the plaintiffs "were members of a class who would obviously be affected by the contravening conduct".[30] In previous securities class actions it was necessary to prove individual reliance by each member of the class. This did not prevent a plaintiff from bringing a class action claim in Australian courts as plaintiffs were able to satisfy the requirements for commencing class actions. However, the application of indirect causation in these cases would make causation a common issue and easier to prove. The difficulties created by a direct reliance requirement were set out in the settlement approval judgment for the Oz Minerals Ltd shareholder class action where Emmett J recounted Oz Minerals position as follows:

> Oz Minerals contended that, in order to recover loss and damage, each group member needed individually to establish actual reliance on the alleged misconduct of Oz Minerals in acquiring its

[26] M Legg, J Emmerig and G Westgarth, "US Supreme Court Revises Fraud on the Market Presumption: Ramifications for Australian Shareholder Class Actions" (2015) 43 ABLR 448, 461.

[27] *In the matter of HIH Insurance Ltd (in liq)* (2016) 113 ACSR 318 [41].

[28] *In the matter of HIH Insurance Ltd (in liq)* (2016) 113 ACSR 318 [105].

[29] See *Guglielmin v Trescowthick (No 2)* (2005) 220 ALR 515, [73]; *Johnston v McGrath* (2005) 195 FLR 101 [28]-[32]. See also *Kaze Constructions Pty Ltd v Housing Indemnity Australia Pty Ltd* [1990] ATPR 41-017, 51,317.

[30] *In the matter of HIH Insurance Ltd (in liq)* (2016) 113 ACSR 318 [74].

> securities during the relevant period. That, Oz Minerals suggested, would be forensically difficult. Each group member would have to prove reliance, having regard to his or her own individual facts, circumstances and investment behaviour.[31]

As a result, while it is still necessary to demonstrate that the contravening conduct misled the market with the result that the share price was inflated, securities class actions that would otherwise not be legally or financially viable due to concerns about demonstrating direct reliance may become so in the wake of *HIH Insurance*.

Conversely, the key ramification of this decision for corporate defendants is the increased risk that share price declines will lead to claims by shareholder plaintiffs. Corporations that are listed on the Australian Securities Exchange are now exposed to potentially successful indirect causation claims of both individuals and class actions. As most shareholder class actions settle, the recognition of indirect causation may also impact the dynamics of settlement negotiations.

Conclusion

HIH Insurance is a significant case with major ramifications for both shareholder class actions and defendant corporations. However, it is important to note that *HIH Insurance* is a first instance New South Wales Supreme Court decision. This authority remains to be tested at an appellate level. Indeed, given the wide-ranging ramifications for shareholders, securities class actions and corporations, not to mention the Court of Appeal decisions against indirect causation in *Digi-Tech* and *Ingot*, commercial certainty may not be established until the High Court reviews this issue.

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[31] *Hobbs Anderson Investments Pty Ltd v Oz Minerals Ltd* [2011] FCA 801 [10].