



## Indirect Causation Accepted by Australian Court in Shareholder Claim

### Key Points

- Traditionally, Australian courts have held that shareholders alleging corporate contraventions of prohibitions on misleading conduct must demonstrate that they were aware of, and directly relied on, the corporate misconduct.
- However, in recent cases the concept of indirect or market-based causation has been held as arguable, without being authoritatively adopted. Shareholders have argued that they rely on the share price as an accurate reflection of share value. Therefore, when corporate misconduct inflates the share price, the company indirectly causes shareholders to suffer loss. Direct reliance is not required.
- In the decision of *In the matter of HIH Insurance Limited (in liquidation) & Ors* [2016] NSWSC 482, the Supreme Court of New South Wales recognised and applied indirect causation in a shareholder claim.
- Indirect causation is likely to make shareholder class actions easier to commence and prove. This may place listed corporations and their directors at greater risk of class action litigation.

### Background

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 2001* (Cth), s 12DA of the *Australian Securities and Investments Commission Act 2001* (Cth) 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.

## The Decision

Brereton J identified two key questions with regards to whether the plaintiffs could claim damages without establishing direct reliance on the misleading financial results:

1. Whether the plaintiffs were entitled to claim damages on the basis of “indirect causation”; and
2. If so, how to establish if the contravening conduct had indirectly caused damages and how to quantify those damages.

## Indirect Causation: Sufficient to Satisfy a Cause of Action

Brereton J found that indirect causation is available to shareholder plaintiffs claiming misleading and deceptive corporate conduct, and that direct reliance need not be established.

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 required 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,<sup>1</sup> 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”.<sup>2</sup>

The judgment supports 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* (2009) 238 CLR 304, Gummow, Hayne, Heydon and Kiefel JJ stated that reliance is not a substitute for causation.<sup>3</sup>

In addition, particular emphasis was placed upon *Janssen-Cilag Pty Ltd v Pfizer Pty Ltd* (1992) 37 FCR 526, where the Federal Court held that under s 82 of the *Trade Practices Act*, plaintiffs may claim compensation 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 a market as a whole.

Second, Brereton J considered recent cases which 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* [2015] FCAFC 94.<sup>4</sup> In the same year, Perram J commented in obiter in *Grant-Taylor v Babcock & Brown Limited (In Liquidation)* [2015] FCA 149 that an investor could recover damages against a company that had failed to comply with its continuous disclosure obligations without proving a direct causal link between the non-disclosure and their loss.<sup>5</sup> 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.<sup>6</sup>

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* (2004) [2004] NSWCA 58 and *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* (2008) 73 NSWLR 653. 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 which provided a sufficiently high valuation of the products to allow the investment scheme to go ahead, and investors suffered loss.<sup>7</sup> 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.<sup>8</sup> 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.<sup>9</sup>

His Honour concluded that shareholders are able to recover losses they have suffered if four conditions are met:

1. A company releases misleading results to the market;
2. The market is deceived into a misapprehension that the company is trading more profitably than it really is;
3. The shares of the company trade at an inflated price; and
4. Investors pay the inflated price for the shares and thereby suffer loss.

## Establishing Indirect Causation and Quantifying the Plaintiffs’ Damages

The Court 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.

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 which 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 which they would have acquired in any event.

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. Second, 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.

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.<sup>10</sup>

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.

## The Missing Step: Assuming an Efficient Market

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

[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.<sup>11</sup>

It seems implicit in this statement that his Honour is assuming 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 distinguishes 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 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.<sup>12</sup>

The Court appears to recognize that an efficient market is a necessary precondition for a successful indirect causation claim. His Honour notes 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.<sup>13</sup> Yet Brereton J never directly addresses 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.<sup>14</sup>

## Ramifications of this Decision

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.

Firstly, this decision will provide plaintiffs with more opportunities to make a successful claim in securities cases involving alleged corporate contraventions. With the advent of HIH Insurance, shareholder plaintiffs are now required to satisfy a lower threshold, that of demonstrating that the relevant conduct was misleading and that it 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.

Further, whilst 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 comments that the plaintiffs "were members of a class who would obviously be affected by the contravening conduct".<sup>15</sup> 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. However, the application of indirect causation in these cases would make causation a common issue and easier to prove, provided it can be shown that the contravening conduct misled the market, causing inflated share prices. As a result, securities class actions that would otherwise not be financially viable or marketable due to concerns about demonstrating 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.

Before concluding, 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.

## Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our “Contact Us” form, which can be found at [www.jonesday.com/contactus/](http://www.jonesday.com/contactus/).

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## Endnotes

- 1 *Wardley Australia Ltd v Western Australia* (1992) 175 CLR 514 at 525.
- 2 *In the matter of HIH Insurance Limited (in liquidation) & Ors* [2016] NSWSC 482 at [42].
- 3 *Campbell v Backoffice Investments Pty Ltd* (2009) 238 CLR 304 at 351.
- 4 See Jones Day, “[Market-Based Causation Arguable in Australian Shareholder Class Actions](#)” (September 2015).
- 5 See Jones Day, “[Class Actions in Australia: 2015 in Review](#)” (March 2016).
- 6 *Grant-Taylor v Babcock & Brown Limited (in liquidation)* [2016] FCAFC 60.
- 7 *Digi-Tech (Australia) v Brand* (2004) [2004] NSWCA 58 at [158].
- 8 *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* (2008) 73 NSWLR 653 at [601].
- 9 *In the matter of HIH Insurance Limited (in liquidation) & Ors* [2016] NSWSC 482 at [74].
- 10 *In the matter of HIH Insurance Limited (in liquidation) & Ors* [2016] NSWSC 482 at [126].
- 11 *In the matter of HIH Insurance Limited (in liquidation) & Ors* [2016] NSWSC 482 at [80].
- 12 Michael Legg, John Emmerig and Georgina Westgarth, “US Supreme Court revises fraud on the market presumption: Ramifications for Australian shareholder class actions” (2015) 43 *Australian Business Law Review* 448 at 461.
- 13 *In the matter of HIH Insurance Limited (in liquidation) & Ors* [2016] NSWSC 482 at [41].
- 14 *In the matter of HIH Insurance Limited (in liquidation) & Ors* [2016] NSWSC 482 at [105].
- 15 *In the matter of HIH Insurance Limited (in liquidation) & Ors* [2016] NSWSC 482 at [74].