wotton kearney

Australia adopts market-based causation (aka fraud on the market) for the first time

***HIH Insurance Limited (In liquidation) & Ors* [2016] NSWSC 482**

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The one outstanding issue in all shareholder/investor class actions is whether the claimants have to individually establish reliance on the contravening conduct, or whether they can rely on a "*fraud on the market"* or *"market based causation"* theory.

In a recent judgment of the NSW Supreme Court in *HIH Insurance Limited (In liquidation) & Ors* [2016] NSWSC 482, Justice Brereton held that HIH Shareholders who acquired shares at prices which were inflated, due to misleading and deceptive financial results, could recover the difference between the false price at which the shares were purchased and real market price, despite not having read or relied upon the financial statements.

Under market-based causation (a form of indirect causation effectively the same as *"fraud on the market"* in the US) there is no need to prove reliance upon any misrepresentation, if that statement nevertheless *"deceived"* the entire market by falsely inflating the asset price (typically shares) subsequently purchased by the plaintiff. Previously, there was uncertainty as to whether this type of indirect causation was available in Australia.

PREVIOUS AUTHORITIES

There are two competing Australian lines of authority, one in favour of, the other against, indirect causation. Unsurprisingly, the plaintiffs adopted the former and the defendant the latter.

A number of cases have established that causation does not necessarily require that a plaintiff prove that it directly relied upon a defendant's misrepresentation, if that statement has mislead third parties who have then acted to the plaintiff's detriment. The typical example is where the defendant's misrepresentation resulted in customers buying the defendant's goods in preference to the plaintiff's.[1] However, in recent times courts have also indicated that this may be extended to market-based causation where the plaintiff relies on the market in setting the price paid,[2] but no judgment had been handed down on the issue, until now.

The alternative line of authorities[3] provided that:

- Indirect reliance was only available where the plaintiff is a *passive* victim of a third party relying upon the defendant.
- Direct reliance on the contravening conduct was required in all cases where the plaintiff is an *active* participant (e.g. by entering into a transaction).

This latter principle prevented a plaintiff from recovering where it had not relied upon the defendant's conduct directly, but instead relied upon a third party which had been misled by the

[1] Most famously epitomised by *Janssen-Cilag Pty Limited v Phizer Pty Ltd* (1992) 37 FCR 526.
[2] *Grant-Taylor v Babcock and Brown (In Liq)* [2015] FCA 149 and *Caason Investments Pty Ltd v Cao* [2014] FCA 1410].
[3] The leading judgments are *Digitech (Australia) v Brand* [2004] NSWCA 58 and *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* (2008) 73 NSWLR 653.

defendant. Plaintiffs in recent high profile class actions such as *Timbercorp* and *Great Southern*[4] have failed due to the application of this principle because they relied upon financial advisors (and not company prospectuses).

JUDGMENT

The issue before Brereton J was whether the plaintiffs' losses were *"caused by"* the alleged contravening conduct. Justice Brereton noted that the facts of *HIH Insurance* did not readily fall into either category of the competing authorities, because market-based causation essentially involved indirect *causation* rather than indirect *reliance*.

The plaintiffs had not relied upon any third parties (as in the other authorities) but instead trusted the market pricing mechanism, which was distorted by the defendant. In allowing the plaintiffs' case of market based causation, Justice Brereton gave a number of further reasons. First, he noted that section 82 of the Trade Practices Act 1974 did not require reliance but merely called for a broader notion of causation. Second, he distinguished the case from the *Digitech* and *Ingot* line of authorities because those were *"no transaction"* cases,[5] whereas market-based causation always assumed a transaction would occur and the enquiry was into the price of that transaction. Third, he relied on *ABN AMRO Bank NV v Bathurst Regional Council*[6] to the extent it supported indirect causation and sought to minimise the scope of the *Digitech* and *Ingot* line of authorities. Fourth, he stated that while there was no authority conclusively allowing market-based causation, there was recent favourable commentary on the principle.[7] Finally, His Honour noted that it was well established that a market may be deceived, manipulated or distorted.[8] On that basis, His Honour concluded that the misleading financial results caused the plaintiffs' loss because they falsely inflated the market price at which the plaintiffs bought the HIH shares.

IMPLICATIONS

There is no doubt that this is a most important judgment with far reaching implications, which also means that it is likely to be subject to an appeal. However, the judgment is not unexpected as the issue had to be determined one way or the other eventually, and unfortunately there is currently no viable alternative. Arguably, it would defeat the entire purpose of class actions if it was ultimately necessary for each and every class member to establish individual reliance.

However, there are some limitations on both the decision's operation and impact, which have not necessarily been highlighted in other commentary. Notably:

- In a *"no transaction case"*, where a plaintiff argues that it would not have purchased a financial product but for the defendant's conduct, the judgment leaves it open for courts to require direct reliance by the plaintiff, in accordance with the previous no transaction case authorities. This would likely encapsulate claims to do with reliance on IPOs or a PDS (such as in *Great Southern, Timbercorp* and *RiverCity*).
- This case does not affect most misleading and deceptive conduct claims under the Corporation Act 2001, ASIC Act 2001, or Australian Consumer Law. That is because in most cases where reliance is contested, the plaintiff has not relied upon the market, but instead relied upon a third party who was in turn misled by the defendant. In those cases, it seems that reliance remains a necessary ingredient.

[4] In a draft judgment released as part of a s33V class action settlement approval.
[5] i.e. the plaintiff would not have made the investment or entered into the transaction but for the contravening conduct
[6] [2014] FCAFC 65.
[7] Statements in *McBride & Christies Australia Pty Ltd* [2014] NSWSC 1729 and *Grant–Taylor v Babcock and Brown* (In Liq) [2015] FCA 149 and the recent refusal of the Federal Court in *Caason Investment Pty Ltd v Cao* [2015] FCAFC 94 to strike out a market based causation pleading because it had reasonable prospects of success.
[8] (*HTW Valuers (Central Qld) Pty Ltd v Aston Land Pty Ltd* [2004] HCA 54.

Market based causation also has some logistical issues, in that it relies on an "efficient" market. This notion has been the subject of much criticism both in the US and in Australia and, given current market issues,[9] the efficiency of the market must be increasingly in doubt. The notion also relies heavily on expert evidence which can be problematic when there are competing influences on a share price.

The real impact of this judgment will be on shareholder class actions and specifically those where shares have been purchased at allegedly inflated prices. Unless a successful appeal is mounted, insurers and insureds alike should be alive to the brave new world of market-based causation in NSW, and likely Australia.

For further information please contact: **www.wottonkearney.com.au**

Patrick Boardman
PARTNER
Sydney Office
T: +61 2 8273 9941
patrick.boardman@wottonkearney.com.au

Jonathon Lees
SPECIAL COUNSEL
Sydney Office
T: +61 2 8273 9942
jonathon.lees@wottonkearney.com.au

[9] For example, a world of negative interest rates and the Bank of Japan printing money to purchase bonds and shares – such that it is now a 10% shareholder in most of the largest Japanese companies – see AFR article dated 25 April 2016.