



## Précis Paper

### Shareholder Litigation and Indirect Market Causation

This presentation involves a discussion of shareholder litigation brought against HIH Insurance Limited (in liquidation). The decision of the NSW Supreme Court in *In the matter of HIH Insurance Limited (in liq) & Ors* [2016] NSWSC 482 is the only final judgment of a superior court in Australia to consider the indirect market-based causation theory.

#### Discussion Includes

- Background and material facts
- Interlocutory issues arising in the proceedings
- Evidentiary issues in shareholder litigation
- Elements involved in establishing market-based causation
- The US fraud on the market theory
- Quantifying loss

## Précis Paper

# Shareholder Litigation and Indirect Market Causation

1. In this edition of BenchTV, Joseph Scarcella (Partner – Ashurst, Sydney) and Jemaya Barlow (Senior Associate – Ashurst, Sydney) discuss the NSW Supreme Court's consideration of indirect market-based causation theory in the recent case of *In the matter of HIH Insurance Limited (in liq) & Ors* [2016] NSWSC 482. Mr Scarcella and Ms Barlow acted for the liquidators of HIH and scheme administrators of HIH Group, the defendants in the proceedings.

### Background and Material Facts

2. The collapse of the HIH Group in March 2001 was Australia's largest corporate collapse. The collapse led to the instigation of a Royal Commission, which in turn led to the successful prosecution of several of HIH's directors including Rodney Adler and Ray Williams. The HIH Group is vast and complex, having businesses in many countries and assets in Australia and the United Kingdom.
3. *In the matter of HIH Insurance Limited (in liq) & Ors* [2016] NSWSC 482 was a proceeding commenced by approximately 3000 shareholders seeking recovery from HIH for certain misleading and deceptive conduct which was effectively established by the Royal Commission. The case is significant as it is the only final judgment in Australia that has considered the indirect market-based causation theory, which is similar to the US "fraud on the market" theory. Specifically, shareholders claimed that they suffered loss by buying shares in a market that was affected by misleading information disseminated by HIH or some of its subsidiaries. The plaintiffs sought to establish their claim by first proving by expert evidence that the market was inflated during a specific period, and second, demonstrating through documents that the plaintiff bought shares during the relevant period.
4. The proceedings were brought under s 1321 of the *Corporations Act 2001* (Cth) which provides a right of appeal from a decision of a liquidator or scheme administrator rejecting a proof of debt. The shareholders commencing these proceedings had submitted proofs of debt claiming that they had suffered loss by buying shares in a market that was poisoned by HIH's misleading conduct. The liquidators rejected these proofs of debt on basis that no causation was established between the alleged loss and HIH's conduct. The proofs of debt were essentially rejected because the shareholders had failed to establish traditional reliance on any misleading or deceptive conduct, nor had they established indirect

reliance, and there was no basis in Australian law at the time for a claim based on market-based causation. The proceedings were organised by a litigation funder.

5. Four separate proceedings were commenced. The first proceeding, which had approximately 16 plaintiffs, was commenced in the Federal Court of Australia. The second, third and fourth proceedings were commenced in the NSW Supreme Court. The third proceeding had approximately 3000 plaintiffs.

#### Interlocutory Issues arising in the Proceedings

6. The first interlocutory issue that arose was whether all four proceedings should be heard together and, if so, in which court. From the perspective of the liquidators, it was undesirable to dispute two matters concurrently in different courts, and the separate proceedings also ran the risk of inconsistent judgments being handed down in respect of the same subject matter by two different courts.
7. The first set of proceedings, filed in the Federal Court, were the furthest advanced, and the plaintiffs filed an application seeking to transfer the later in time Supreme Court proceedings into the Federal Court. The Supreme Court heard the matter and determined that there were two factors that militated against a transfer to the Federal Court. First, the Supreme Court proceedings had over 3000 plaintiffs, whereas the Federal Court proceeding had only 16. Second, the NSW Supreme Court was the court that had wound up HIH and had supervisory jurisdiction over the liquidators. On that basis, the Court ordered that the Federal Court proceedings be transferred to the NSW Supreme Court and all four proceedings be heard concurrently: *In the matter of HIH Insurance Limited (In Liquidation)* [2014] NSWSC 545.
8. A second interlocutory matter related to the third proceeding which had over 3000 plaintiffs. In this proceeding, as an alternative to the indirect market-based causation argument, it was submitted that each plaintiff had relied upon specific misleading and deceptive statements made by HIH. This was a traditional reliance case made under s 52 of the *Trade Practices Act 1974* (Cth) (now s 18, *Competition and Consumer Act 2010* (Cth)).
9. The interlocutory issue arose in the context of proving this aspect of the claim. With over 3000 plaintiffs involved, there was a question of how to manage the evidence, given that over 3000 individuals were claiming specific reliance on particular words or conduct of HIH. The Court made it clear that it would not entertain cross-examination of over 3000 people, or affidavits from every individual in relation to their reliance. There was discussion between the Court and the parties about how this issue would be broached, and one option proposed was that each party would choose 10 plaintiffs randomly to be cross-

examined on reliance, with that evidence standing as a model or test for all plaintiffs. This approach was unsatisfactory to the defendants, as they considered that they were entitled to test by cross-examination the evidence of each plaintiff. Ultimately, however, the Court did not have to address this issue, as it decided to deal with the market-based causation case first, and only if this was unsuccessful, return to the traditional reliance case.

10. The final interlocutory issue related to the ability of the plaintiffs to bring the proceedings. The litigation funder was authorised to lodge proofs of debt and receive dividends, but was not authorised in all circumstances to commence proceedings, nor were the solicitors on the record. The defendants brought a strike out application on the basis that the solicitors were not authorised to commence proceedings. The consequence of the shareholders not authorising the commencement of proceedings on their behalf was that they were unaware that they would be exposed to adverse costs orders if they lost the proceedings. The strike out application ultimately resulted in the striking out of the proceedings in relation to 1600 plaintiffs: *In the matter of HIH Insurance Limited (in liquidation); Smith & ors v McGrath & ors; Baldock & ors v McGrath & ors* [2014] NSWSC 922.

#### Market-Based Causation Theory

11. The theory of market-based causation is based on the premise that if a company engages in misleading or deceptive conduct or otherwise misleads the market in relation to its continuous disclosure obligations, and that conduct leads to an inflated share price, shareholders who acquired shares during the inflated price period are entitled to recover loss from the company. Shareholders must also establish that they did not know the truth about the contravention, or were not indifferent to the contravention.
12. Market-based causation differs from the traditional theory, under which it must be established that the shareholder relied upon certain information that was disseminated by the company which caused the shareholder to suffer loss. The market-based causation theory suggests that no reliance is necessary; it functions on the premise that the market is misled and a shareholder only needs to prove that the share price was inflated by reason of the conduct of the company. Prior to HIH, the only court that had considered market-based causation was the Federal Court in *Grant-Taylor v Babcock and Brown Ltd (in liq)* [2015] FCA 149. In that case, Perram J, stated in obiter (at [220]):

*A party who acquires shares on a stock exchange can recover compensation for price inflation arising from a failure to disclose material ... so long as they are not themselves aware of the non-disclosed material.*

13. The market-based causation theory derives from the US fraud on the market theory. Under that theory, investors are presumed to have relied on public misstatements whenever they buy or sell shares at the market price, provided that the stock is traded on an efficient market; the alleged misrepresentation is publicly known; and that the relevant transaction took place after the misrepresentations were made and before the truth was revealed to the market. The US doctrine requires evidence as to the degree of efficiency of the market, and typically arises after a market correction, which is *prima facie* evidence that the investor has suffered loss.
14. In this case, the shareholders alleged that all of the wrongdoing attributable to HIH by the Royal Commission resulted in HIH publishing misleading and deceptive financial statements. The publication of these misleading statements was said to have caused loss to the shareholders because the shareholders purchased shares in a market that was inflated by reason of the misleading conduct.
15. To establish their case, the shareholders sought to rely upon the Royal Commission and other criminal convictions of the directors of HIH. This evidence was held to be inadmissible. However, the liquidators, being officers of the Court, could not deny some of the misleading conduct of HIH. A Statement of Facts was agreed which set out the nature and extent of HIH's misleading conduct.
16. The Statement of Agreed Facts provided that HIH incorrectly accounted for two reinsurance contracts, which were then incorporated into the accounts of three subsidiary companies of HIH. The shareholders alleged that the incorrect accounting treatment of the two reinsurance contracts caused the profits and net assets of HIH and its subsidiaries to be overinflated. This information was then published to the shareholders and the market. The publication of this information was said to amount to misleading and deceptive conduct by HIH, and to have caused HIH's shares to be traded at a higher price than it otherwise would have traded, but for the misleading conduct. This was the crux of the market-based causation case.
17. In the US fraud on the market cases, there is usually a correction by the company. As a result of the correction, experts are able to determine what impact the material non-disclosure had on the share price. In the case of HIH, there was no correcting conduct and therefore similar analysis could not be undertaken. Instead, expert analysis sought to map the share price of HIH, taking out the misleading statements from HIH's account. However, the plaintiffs' expert developed this model based upon inadmissible evidence from the Royal Commission, and not the evidence contained in the Statement of Agreed Facts. This evidence was ultimately found to be inadmissible.

18. Consistent with the High Court's position in *Commonwealth v Amann Aviation Pty Ltd* [1991] HCA 54; 174 CLR 64, Brereton J took the view in this case that he could calculate loss suffered by the shareholders by determining the extent to which the share price was overinflated by misleading conduct.
19. His Honour ultimately found that each individual shareholder need not prove reliance upon misleading or deceptive conduct by HIH in order to be entitled to damages. Rather, he found that the conduct of HIH formed part of the matrix that influenced the trading price at which the shareholders purchased shares. If the misleading and deceptive conduct did not occur, the market price of the shares would have been lower. Damages were awarded based on the difference between the price at which the plaintiffs acquired the shares and the price at which the shares would have traded but for the misleading conduct. This amount was unlikely to be significant, as the amount of the inflation was found to be between 6 to 13 percent at a period when the share prices were relatively low.

## **BIOGRAPHY**

### Joseph Scarcella

Partner, Ashurst, Sydney

Joseph is a Partner in the restructuring, insolvency and special situations practice at Ashurst. His work includes complex insolvencies such as multi-jurisdictional hedge fund collapses, finance and insurance company collapses and advising major banks on large syndicated and bilateral exposures. He also often speaks at conferences on issues relating to insolvency.

### Jemaya Barlow

Senior Associate, Ashurst, Sydney

Jemaya is a Senior Associate in the restructuring, insolvency and special situations team at Ashurst. Her practice includes advising distressed companies on restructuring and creative work-out techniques, and advising on traditional insolvency scenarios. Earlier in her career, Jemaya spent 3 years as a solicitor in Hong Kong, where she was involved in several high-profile restructurings.

## **BIBLIOGRAPHY**

### Focus Case

*In the matter of HIH Insurance Limited (in liq); Smith & ors v McGrath & ors; Baldock & ors v McGrath & ors* [2016] NSWSC 482

### Benchmark Link

[https://benchmarkinc.com.au/benchmark/weekly\\_construction/benchmark\\_06-05-2016\\_weekly\\_construction\\_law\\_review.pdf](https://benchmarkinc.com.au/benchmark/weekly_construction/benchmark_06-05-2016_weekly_construction_law_review.pdf)

### Judgment Link

<https://www.caselaw.nsw.gov.au/decision/5716e7dfe4b05f2c4f04d2fc>

### Cases

*In the matter of HIH Insurance Limited (In Liquidation)* [2014] NSWSC 545

*In the matter of HIH Insurance Limited (in liquidation); Smith & ors v McGrath & ors; Baldock & ors v McGrath & ors* [2014] NSWSC 922

*Grant-Taylor v Babcock and Brown Ltd (in liq)* [2015] FCA 149

*Commonwealth v Amann Aviation Pty Ltd* [1991] HCA 54; 174 CLR 64

### Legislation

*Corporations Act 2001* (Cth)

*Trade Practices Act 1974* (Cth) (now *Competition and Consumer Act 2010* (Cth))

