MARSH

MAY 2016

CLIENT ALERT

'FRAUD ON THE MARKET' THEORY IN AUSTRALIA? -IN THE MATTER OF HIH INSURANCE LIMITED (IN LIQUIDATION) & ORS [2016] NSWSC 482

INTRODUCTION

Generally it has been thought that in order for a shareholder or class of shareholders to succeed in a securities action against a company, it or they must essentially prove that it or they:

- relied upon the company's allegedly fraudulent conduct in purchasing or selling securities, and
- that the company's conduct caused, at least in part, it/their loss.

These two elements are known in the United States, respectively, as "transaction causation" and "loss causation".

POSITION IN THE UNITED STATES

Since the Supreme Court of the United States in *Basic Inc v Levinson 485 US 224 (1988),* United States courts have embraced the 'fraud on the market theory' in relation to transaction causation, which essentially does away with the need for members of a class to prove actual reliance on the companies misleading representations on the basis that there is a presumption that an efficient market exists where share prices fluctuate according to publicly available information about the company. A defendant may rebut the presumption showing:

- that the market price of the shares was not influenced by the non-disclosure;
- the aggrieved investors would have purchased the shares at the same price notwithstanding the non-disclosure; and
- the aggrieved investors knew the information that was not disclosed.

The 'fraud on the market theory' does not extend to loss causation; that is an exaggerated purchase cost alone will not establish or proximately cause the pertinent economic damage needed to claim and demonstrate 'loss causation'.

THE POSITION IN AUSTRALIA

Australian courts have not adopted the 'fraud on the market theory' as accepted in the United States. Prior to the case of *In the matter of HIH Insurance Limited (in liquidation) & Ors [2016] NSWSC 482* shareholders were required to show individual reliance on the misrepresentations in making their decision to purchase or sell the relevant securities.

IN THE MATTER OF HIH INSURANCE LIMITED (IN LIQUIDATION) & ORS [2016] NSWSC 482

The matter was brought by shareholders in HIH Insurance Limited (HIH) who acquired HIH shares in the period between 26 October 1998 and 15 March 2001 (the plaintiffs) against the liquidators of HIH and scheme administrators of FAI General Insurance Company Limited ("FAI") and HIH Casualty & General Insurance Limited ("C&G") which were subsidiaries of HIH.

The plaintiffs contended that they acquired shares at prices which were inflated by representations made by HIH in certain financial results. These representations were admitted. The plaintiffs contended that the representations were misleading and deceptive, or likely to mislead or deceive. As a result the plaintiffs were entitled to damages pursuant to s 82 of the *Trade Practices Act* (TPA) and s 1005(1) of the *Corporations Law.*

The plaintiffs did not contend that they read, or directly relied upon reports of the financial results. However, they contended that they acquired HIH shares in a market regulated by the ASX and the Corporations Law, but which was distorted by the admitted misrepresentations of the financial results, so that shares in HIH traded at prices higher than those which would have obtained had the misrepresentations not been made; and that they have suffered loss and damage by reason of having paid more for the shares they acquired than they would otherwise have paid.

The plaintiffs lodged proofs of debt in respect of their claimed losses. The defendants, as liquidators and scheme administrators, did not admit their proofs.

Justice Brereton referred to the 'fraud on the market theory' as established in the United States under which reliance can be presumed, but noted that, "... this doctrine does not avail the plaintiffs because Australian law does not authorise any rebuttable presumption of this kind".

However Justice Brereton noted that s 82 of the TPA gives a cause of action for damages to "a person who suffers loss or damage by the conduct of another person" finding that "the ultimate issue posed by the TPA, s 82 (and its equivalents) is one of causation, not one of reliance".

In reviewing Australian case-law Justice Brereton referred to the concept of indirect market based causation, noting that "while there appears to be no authoritative decision that conclusively holds that market causation is available, there are ... the decisions ... which ... appear to regard such a theory as available ..."

Justice Brereton noted that this was not a case where no-one was misled on the basis that "while the contravening conduct did not directly mislead the plaintiffs, it deceived the market".

Justice Brereton went on to find that the absence of direct reliance by the plaintiffs on the overstated accounts did not deny 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 were traded to be distorted, which in turn caused loss to investors who acquired the shares in that market at the distorted price.

However, Justice Brereton noted that this did not mean that indirect causation has been established. The plaintiffs must 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.

CONCLUSION

- The case does not accept 'fraud on the market theory' as that term is understood in the United States, it expressly rejects the concept of a rebuttable presumption of reliance.
- The case deals with s 82 of the TPA, noting that the ultimate issue posed by this section and its equivalents is one of causation, not one of reliance. This may not be the case in relation to other causes of action.
- The case embraces the concept of indirect market based causation.
- This is a first instance judgment. For the concept of indirect market based causation to be firmly entrenched in Australia in relation the securities actions generally will require a High Court decision.
- The case does not deal with and appears to have no impact upon the coverage provided by Directors' & Officers' policies in relation to securities actions.

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