CAUSATION IN SECURITIES CLASS ACTIONS

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I INTRODUCTION

There has been a marked increase in the number of securities class actions commenced against listed companies in Australia in recent years,[1] but no case has proceeded to final judgment. There was a trial in the shareholder class action against Aristocrat Leisure Limited ('Aristocrat') in October 2007, but that case was settled prior to a judgment being delivered by the Federal Court. The Aristocrat trial did, however, highlight the critical importance of causation issues in securities class actions.

Causation is an essential element of the causes of action that form the basis for most securities class actions in Australia – misleading or deceptive conduct and breach of continuous disclosure obligations. For a claimant to establish an entitlement to compensatory damages under either cause of action, it must establish that the contravening conduct caused its loss.

There is, however, a serious question as to what a claimant must do in a securities claim to establish causation. In particular, whether it is necessary for a claimant to prove that it relied on the contravening conduct in making decisions in connection with the purchase or sale of the relevant securities – often referred to as a direct approach to causation. Alternatively, it has been argued that the causation requirement can be satisfied by general notions of reliance by the market as a whole affecting the price at which a claimant purchased or sold its securities – often referred to as an indirect approach to causation.

The answer to this question will determine whether causation can be dealt with as a common issue in securities class actions. If an indirect approach to causation is sufficient, causation will be a common issue and the claims of all group members will be dealt with collectively. If, however, direct causation for

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1 Prior to the commencement of the Aristocrat proceedings in November 2003, there had been only one major securities class action in Australia: see *King v AG Australia Holdings Ltd (formerly GIO Australia Holdings Ltd)*, Federal Court of Australia, Matter N 955 of 1999. Since that time, at least 11 other actions have been commenced and many others have been foreshadowed.

each claimant is required, causation will be an individual issue and each group member will need to prove that the company's contravening conduct caused its loss.

Whether or not causation can be dealt with as a common issue has significant ramifications for the way securities class actions are conducted. It is also likely to be a significant factor in determining whether potential actions are economically viable for litigation funders or other sponsors.

The issues relating to causation in the securities class action context were canvassed at length at the trial of the Aristocrat shareholder class action – the first securities class action to proceed to trial in Australia (and, at the time of writing, the only securities class action to do so). It was expected that the judgment in that case would provide an answer to many of the questions relating to causation in this context. However, with the settlement of that case prior to judgment, the test for causation remains unresolved. This paper outlines the issues relating to causation in the securities class action context with a particular focus on the way those issues were approached in the *Aristocrat* case. It then concludes with an explanation of the basis for our opinion that a direct approach to causation is required by the authorities and should also be preferred as a matter of policy.

II THE ARISTOCRAT SHAREHOLDER CLASS ACTION

Aristocrat is an Australian gaming technology company that manufactures and distributes gaming hardware and software (predominantly poker machines). Its shares are listed on the Australian Securities Exchange ('ASX').

The class action proceedings were commenced in November 2003 and were known as *Dorajay Pty Ltd v Aristocrat Leisure Limited*.[2] The proceedings were conducted in the Federal Court as representative proceedings pursuant to Part IVA of the *Federal Court of Australia Act 1976* (Cth).[3]

The proceedings were brought by Dorajay Pty Ltd ('Dorajay') on its own behalf and on behalf of all persons who acquired an interest in shares in Aristocrat in the period between 19 February 2002 and 26 May 2003 and who suffered loss or damage by or resulting from Aristocrat's alleged contravening conduct.[4]

The trial of Dorajay's claim (which encompassed the common issues affecting all group members) took place over 12 days in October 2007 before Stone J. A conditional settlement was announced by the parties in May 2008 prior to her Honour delivering judgment. The Court approved the terms of the

2 Federal Court of Australia, Matter NSD 362 of 2004.

3 The proceedings were originally commenced in the Supreme Court of Victoria (Matter 8983 of 2003). The proceedings were transferred to the New South Wales Registry of the Federal Court pursuant to the *Jurisdiction of Courts (Cross-Vesting) Act 1987* (Vic) in March 2004.

4 Sixth Further Amended Statement of Claim (2 November 2007) [2].

settlement in August 2008.[5] The proceedings were dismissed by the Court in October 2009.

The catalyst for the proceedings was the announcement by Aristocrat of profit downgrades in two consecutive reporting periods, which resulted in its share price falling from $4.22 in early February 2003 to a low of $0.76 in late May 2003. The circumstances relating to the profit forecasts and the subsequent profit downgrades were the initial focus of the proceedings. Following discovery, the focus was expanded to include issues relating to the validity of Aristocrat's recognition of revenue from certain contracts with South American customers in its 2001 and 2002 half-year accounts.

The principal claims made in the proceedings at the time of the trial were that:

(a) Aristocrat engaged in misleading and deceptive conduct when it announced its results for 2001 and the first half of 2002 because those results included revenue from certain South American contracts which the accounting standards did not allow it to recognise in the relevant reporting periods.

(b) Aristocrat engaged in misleading and deceptive conduct when it impliedly represented to the public that its accounts were prepared in accordance with the accounting standards, that it would achieve its profit forecasts made from time to time and that it had not engaged in misleading or deceptive conduct nor breached its continuous disclosure obligations. These implied representations were said to arise from the fact that the company had made certain public statements.

(c) Aristocrat breached its continuous disclosure obligations by not disclosing to ASX certain information relating to:

  (i) its performance of the South American contracts and the collectability of revenue under those contracts; and

  (ii) the likelihood of it achieving the market consensus for its 2002 profit.[6]

Dorajay and the group members claimed damages and interest. Some group members also claimed consequential loss.[7]

III THE REQUIREMENT OF CAUSATION IN SECURITIES CLASS ACTIONS

The basis for most Australian securities class actions are allegations of:

5 *Dorajay Pty Ltd v Aristocrat Leisure Limited* [2009] FCA 19 (Unreported, Stone J, 21 January 2009).

6 Sixth Further Amended Statement of Claim (2 November 2007) [179]–[192].

7 Ibid [197], [198]. The consequential loss claims were not, however, addressed during the trial because Dorajay did not make a claim for consequential loss.

- misleading or deceptive conduct in respect of inaccurate or incomplete statements in relation to a company's performance or expected performance; and/or
- breach of a listed company's continuous disclosure obligations (often in respect of matters relating to the company's performance or expected performance, but also in respect of other material aspects of the company's business). [8]

As mentioned above, both of these causes of action require a claimant to establish that the contravening conduct caused its loss. It is not, however, necessary for the contravening conduct to be the sole cause of the loss.[9]

The misleading or deceptive conduct provisions most relevant in the securities class action context are:

- section 1041H of the *Corporations Act 2001* (Cth) ('*Corporations Act*') (misleading or deceptive conduct in relation to a financial product or a financial service);
- section 12DA of the *Australian Securities and Investments Commission Act 2001* (Cth) ('*ASIC Act*') (misleading or deceptive conduct in trade or commerce in relation to financial services); and
- to a lesser extent, section 52 of the *Trade Practices Act 1974* (Cth) ('*TPA*') (misleading or deceptive conduct in trade or commerce).[10]

Section 1041I of the *Corporations Act*, section 12GF of the *ASIC Act* and section 82 of the *TPA* respectively provide a right to compensation for losses arising from a breach of the provisions referred to in the preceding paragraph. Each provision provides a right to compensation in respect of loss suffered 'by' the contravening conduct.

The continuous disclosure obligations of a company whose stock is listed on the ASX are set out in Rule 3.1 of the ASX Listing Rules. Section 674 of the *Corporations Act* is a 'financial services civil penalty provision', which obliges a listed entity to disclose to the ASX information required to be disclosed by the ASX Listing Rules if that information is not generally available and is information that a reasonable person would expect to have a material effect on the price or value of the entity's stock. Section 1317HA of the *Corporations Act* provides a right to compensation in respect of loss which 'resulted from' a breach of a financial services civil penalty provision including section 674.

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8 For example, the Aristocrat, Multiplex and Centro shareholder class actions involve allegations of both misleading and deceptive conduct and breach of each company's continuous disclosure obligations. The GIO shareholder class action involved allegations of misleading and deceptive conduct only, whereas the Telstra and AWB shareholder class actions involve allegations of breach of continuous disclosure obligations.

9 *I & L Securities Pty Ltd v HTW Valuers (Brisbane) Pty Ltd* (2002) 210 CLR 109, 128.

10 Sections 1041H of the *Corporations Act* and 12DA of the *ASIC Act* do not apply to misleading or deceptive conduct in relation to takeover or fundraising documents. Misleading or deceptive conduct in these contexts is dealt with by ss 670A and 728 of the *Corporations Act*.

The references to 'by' in the statutory provisions under which loss for misleading or deceptive conduct may be recovered and 'resulted from' in section 1317HA of the *Corporations Act* have both been held to require a causal link between the contravening conduct and the alleged loss. For example, in *Adler v ASIC*, Giles JA (with whom Mason P and Beazley JA agreed) said that:

> In my opinion, the words 'resulted from' in section 1317H are words by which, in their natural meaning, only the damage which as a matter of fact was caused by the contravention can be the subject of an order for compensation. Like the word 'by' in s 82 of the *Trade Practices Act 1974* (Cth) (see *Marks v GIO Australia Holdings Ltd* (1998) 196 CLR 494 at [38]-[42]), they should be given their ordinary meaning of requiring a causal connection between the damage and the contravening conduct, free from the strictures of analogy with equitable claims against fiduciaries.[11]

IV THE APPROACH TO CAUSATION IN SECURITIES CLAIMS IN THE UNITED STATES

Securities class actions have become common in the United States since the introduction of the modern class action rule (Rule 23, *Federal Rules of Civil Procedure*) in 1966.[12] As a result, the law applicable to securities class actions in the United States is comparatively well developed and parties involved in, and commentators on, Australian securities class actions have looked to the United States for guidance, particularly on the issues of causation and loss calculation despite significant differences in the underlying legal principles.

There has been particular focus on an approach to causation known as the 'fraud-on-the-market' theory, which has developed in the United States in the specific context of the Securities and Exchange Commission's Rule 10b-5[13] ('Rule 10b-5'). Rule 10b-5 is the basis for most securities class actions under United States federal law.[14]

Rule 10b-5 makes it unlawful, in connection with the purchase or sale of any security, for any person to 'make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading.'

United States courts have implied from Rule 10b-5 a private right of action that enables investors who suffer loss as a result of a breach of the rule to recover

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11 *Adler v ASIC* (2003) 46 ACSR 504, 653. There is no difference between ss 1317H (which applies to corporation/scheme civil penalty provisions) and 1317HA (which applies to financial services civil penalty provisions) for current purposes.

12 See, eg, Michael Duffy, 'Fraud on the Market: Judicial Approaches to Causation and Loss from Securities Nondisclosure in the United States, Canada and Australia' (2005) 29 *Melbourne University Law Review* 621, 624; and Deborah R Hensler, 'Large Scale Litigation: A US Perspective' (2000) 77 *Reform* 67, 68.

13 Adopted pursuant to s 10(b) of the *Securities Exchange Act*, 15 USC § 78a (1934).

14 See, eg, Stanford Law School Securities Class Action Clearinghouse (in cooperation with Cornerstone Research), *Securities Class Action Case Filings 2007: A Year in Review* (2008) 21 (Exhibit 19).

damages from the persons who caused their loss.[15] An essential element of this right of action is reliance by the investor on the contravening conduct.[16]

Up until the mid 1970s, the accepted approach to misrepresentation in the United States was that a claimant who did not hear or read the misrepresentation, but who traded shares notwithstanding, could not recover their loss because they did not rely on the misrepresentation. However, beginning with the Ninth Circuit decision in *Blackie v Barrack*,[17] United States courts have acknowledged the largely impersonal nature of exchange trading for securities and accepted the theory that investors indirectly rely on the representations underlying a stock price. That decision is said to mark the emergence of the fraud-on-the-market approach to causation in the United States.[18]

In 1988, the United States Supreme Court endorsed the application of the fraud-on-the-market theory in claims for breach of Rule 10b-5 in *Basic Inc v Levinson*,[19] creating a rebuttable presumption of reliance for all members of a class alleging misstatements or omissions of material fact in their purchase or sale of shares or other securities. According to Blackmun J:

> The fraud-on-the-market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business … Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements …. The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.[20]

The fundamental premise of the fraud-on-the-market theory is that, when the available information about a company is distorted by misrepresentations or non-disclosures, the company's securities will not be traded at a price that reflects the intrinsic value of the company, but at an artificially inflated or deflated price. Where the price has been artificially inflated in this way, the theory provides that investors will suffer a loss simply by acquiring shares or other securities at the inflated price. A loss may also be suffered when investors sell shares or other securities at an artificially deflated price. In each case, the requirement of reliance on the contravening conduct is satisfied by investors' presumed reliance on the integrity of the market price of the share or other security.

Importantly, the United States Supreme Court made it clear in *Basic* that the presumption of reliance arising from the fraud-on-the-market theory is a rebuttable one.[21] It has subsequently been held that the presumption may be rebutted if the defendant can show that 'an individual plaintiff traded or would

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15 Duffy, above n 12, 624. According to Duffy, this right was first recognised in *Kardon v National Gypsum Co*, 73 F Supp 798, 800, 802–3 (ED Pa 1947).

16 See, eg, *Basic Inc v Levinson*, 485 US 224 (1988) ('*Basic*'), 243.

17 524 F 2d 891 (9th Cir, 1975).

18 Duffy, above n 12, 628.

19 *Basic*, 485 US 224 (1988).

20 Ibid 241–2, quoting *Peil v Speiser*, 806 F 2d 1154, 1160–1 (3rd Cir, 1986).

21 *Basic*, 485 US 224 (1988), 250.

have traded despite his knowing the statement was false'[22] or that any other matter existed 'that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, and his decision to trade at a fair market price'.[23]

The United States Supreme Court also made it clear in *Basic* that the application of the fraud-on-the-market theory is conditional upon, among other things, the necessary conditions for the efficient capital markets hypothesis holding true, including that the market for the particular stock is 'impersonal' and 'well developed'.[24] At its most basic, the efficient capital markets hypothesis is based on the theory that, in developed securities markets, stock prices 'fully reflect all available information'.[25] There are generally considered to be three levels of market efficiency: 'strong' form, in which all information, both public and private, is said to be incorporated into stock prices; 'semi-strong' form, in which all publicly available information is said to be incorporated into stock prices; and 'weak' form, in which all previous stock prices (which are necessarily a subset of all public information) are incorporated into current stock prices.[26]

More recently, in *Dura Pharmaceuticals Inc v Broudo*,[27] the United States Supreme Court held that the fraud-on-the-market theory is only half the answer to the requirement of causation. The Court said that the theory creates a 'non-conclusive' presumption of reliance on the misrepresentation by the claimant ('transaction causation'), but does not address the question of whether or not the inflated price was caused by the misrepresentation ('loss causation'). This is because movements in a share price may be caused by reasons other than the correction of defective disclosures (such as changed economic circumstances, changed investor expectations and/or new industry-specific or firm-specific facts, conditions or other events). The Court made it clear that loss causation (which would clearly be a common issue) is a separate element which must be satisfied to establish an entitlement to damages.

It is often asked whether the fraud-on-the-market theory could (or should) be adopted as the mechanism for dealing with causation in Australian securities claims. This question assumes that the theory, which was developed in the specific context of Rule 10b-5, could be applied to the Australian statutory context. Leaving aside for the moment the question of whether or not the theory is consistent with Australian law and policy, there are at least two significant differences between the relevant substantive law and class action procedures in

22 *Cromer Finance Ltd v Berger*, 205 FRD 113, 129 (SDNY, 2001), quoting *Basic*, 485 US 224 (1988), 248.

23 Ibid.

24 *Basic*, 485 US 224 (1988), 247.

25 Eugene Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *Journal of Finance* 383. The origins of the efficient capital markets hypothesis are generally traced back to that paper by Fama. See also Duffy, above n 12, 631; Paul A Ferrillo, Frederick C Dunbar and David Tabak, 'The Less than Efficient Capital Markets Hypothesis' (2004) 78 *St John's Law Review* 81, 102.

26 Ferrillo, Dunbar and Tabak, above n 25, 102–3 referring to Fama, above n 25. The three levels of market efficient were first suggested by Fama, above n 25, 383.

27 544 US 336 (2005).

Australia and the United States which, in our opinion, mean that the theory should not be adopted in Australia.

First, the presumption arising from the fraud-on-the-market theory in the United States only applies to claims brought under Rule 10b-5, which requires the plaintiff to prove 'scienter' (intent to deceive, manipulate or defraud). United States courts have refused to apply the presumption to common law claims of misrepresentation which, like the causes of action relied upon in Australian securities class actions, do not require evidence of intent to mislead or defraud.[28] It is arguable that, while it may be appropriate on policy grounds to presume reliance where there has been an intent to mislead or defraud investors, it is inappropriate in cases where it is not necessary for there to have been such intent nor is there a defence for due diligence.[29] The argument being that a company which has caused loss should be required to compensate for that loss; but where there has been no intent to mislead or defraud and perhaps also an appropriate level of due diligence, the company should not be punished further by having to compensate for loss not caused by its conduct. Incidentally, Canadian courts have rejected the application of the fraud-on-the-market theory to common law actions for misrepresentation on the basis that the specific context in which the theory was developed (that is, actions for breach of Rule 10b-5) does not directly correlate to the applicable Canadian causes of action.[30]

Second, the fraud-on-the-market theory was developed in the context of the class certification requirement under United States class action laws.[31] Among other things, certification in United States class actions is dependent upon common issues 'predominating' over individual issues. If causation were an element required to be proved separately by each class member, most securities class actions in the United States would not be certified and therefore could not be run. Accordingly, one reason for the development of the fraud-on-the-market theory in the United States was to facilitate certification. In circumstances in which there is no similar requirement of predominance in Australia (it is only necessary that there be at least one substantial common issue of law or fact[32]), there is no similar policy reason for making causation a common issue.

There are other reasons why, in our opinion, adoption of the fraud-on-the-market theory or a similar indirect approach to causation would not be consistent with Australian law and policy. These reasons are discussed below following an

28 *Mirkin v Wasserman*, 858 P 2d 568 (Cal, 1993).

29 See, eg, Ashley Black 'Commentary on All Four Papers' in the Hon Justice K E Lindgren (ed), *Investor Class Actions*, Ross Parson Centre of Commercial, Corporate and Taxation Law (2009) 101, 106–7.

30 *Carom v Bre-X Minerals Ltd* [1998] O.J. No. 4496. See also the discussion in Randy C Sutton, *Securities Class Actions in Canada: The Dawn of a New Era* (2005) Association of Corporate Counsel <http://www.acc.com/vl/public/Article/loader.cfm?csModule=security/getfile&pageid=15968> at 31 July 2009 and Duffy, above n 12, 639.

31 See, for example, Frederick Dunbar and Dana Heller, 'Fraud on the Market Meets Behavioural Science' (2006) 31 *Delaware Journal of Corporate Law* 455, 457–62. See also the comments of Professor Geoffrey Miller at 6 and 112 and Ashley Black at 108 in the Hon Justice K E Lindgren (ed), above n 29.

32 *Federal Court of Australia Act 1976* (Cth) s 33C; *Supreme Court Act 1986* (Vic) s 33C.

outline of the different approaches to causation taken by the parties in the *Aristocrat* case.

V THE APPROACH IN *ARISTOCRAT*: DIRECT CAUSATION V INDIRECT CAUSATION

The appropriate test for causation in Australian securities class actions was the subject of detailed submissions during the *Aristocrat* trial. Although the parties took very different positions on the issue, both parties agreed that the test for causation could be determined by reference to established principles of causation under Australian law.

It is convenient to consider the alternative approaches to causation put forward by the parties as follows:

- 'indirect causation' – under this approach, advocated by Dorajay, the causation requirement is satisfied simply by the acquisition of shares at an inflated price (on the basis that the inflation was caused by the market's reliance on the contravening conduct); and
- 'direct causation' – under this approach, advocated by Aristocrat, the causation requirement is only satisfied when the claimant relied upon the contravening conduct in making the decision to acquire shares at an inflated price.

Dorajay advocated an indirect causation approach in respect of the claim that its (and other group members') loss should be calculated by reference to the amount of 'inflation' in the Aristocrat share price at particular points in time.[33] It was common ground that Dorajay could only be successful in its alternate claim to be compensated on the basis of the difference between the price it paid for its Aristocrat shares and the price for which it sold those shares if it established 'direct causation'.[34]

A The Case for Indirect Causation

The basis for the indirect approach to causation relied upon by Dorajay is the principle that it is not necessary for a claimant to have relied upon the defendant's contravening conduct for the claimant's loss to have been caused by

33 The 'inflation' method of loss calculation is based on the 'rule' in *Potts v Miller* (1940) 64 CLR 282 that the measure of damages in the tort of deceit is the difference between the price paid by the plaintiff upon entry into the relevant transaction and the 'true value' of the asset acquired. On that basis, Dorajay alleged that the presumptive measure of loss for it and other group members was: (a) for all group members – the difference between the price paid for the shares and the 'true value' of those shares at the time of purchase (that is, the amount of inflation in the share price at the time of purchase); and (b) for group members (including Dorajay) who subsequently sold their shares – the amount of inflation in the share price at the time of purchase, plus any subsequent inflation that entered the share price during the period the shares were held, less the amount of inflation remaining in the share price at the time of sale. See Dorajay's written submissions (SJ Gageler SC, MBJ Lee, LWL Armstrong), 28 October 2007 [454].

34 Dorajay's written submissions, above n 33, [458]–[465].

that conduct. This principle arises from the following statement made by Lockhart J in *Janssen-Cilag Pty Ltd v Pfizer Pty Ltd*[35] (which was quoted with approval by Gummow J in *Marks v GIO Australia Holdings Ltd*[36]):

> What emerges from an analysis of the cases (and there are many of them) is that they do not impose some general requirement that damage can be recovered only where the applicant himself relies upon the conduct of the respondent constituting the contravention of the relevant provision.[37]

In *Janssen-Cilag*, Pfizer made misleading and deceptive representations to consumers about one of its pharmaceutical products, as a result of which consumers were induced to purchase Pfizer's product rather than Janssen-Cilag's rival product. It was alleged that Janssen-Cilag suffered loss 'by' Pfizer's conduct despite the fact that it had not directly relied upon that conduct. In allowing Janssen-Cilag's claim for damages under section 82 of the *TPA*, Lockhart J said:

> Whilst the applicant's loss or damage must be caused by the respondent's misleading or deceptive conduct, I see nothing in the language of the [Trade Practices] Act or its purpose to warrant the suggestion that the right of an applicant for damages under s82 is confined to the case where he has relied upon or personally been influenced by the conduct of the respondent which contravenes the relevant provision of Pt IV or Pt V of the Act …
>
> … Where a corporation engages in conduct which misleads consumers, the natural and direct result of which is to cause the public to buy more of that trader's product and less of a rival trader's product the loss to the rival is direct and immediate; it is not remote or indirect.[38]

Justice Lockhart's findings have been applied and cited with approval in a number of cases, including by the NSW Court of Appeal in *Hampic Pty Ltd v Adams*[39] and the Full Court of the Federal Court in *McCarthy v McIntyre.*[40] In *McCarthy*, the Full Court said:

> With respect, we agree with Lockhart J in *Janssen-Cilag* that there is nothing in s 82 of the [Trade Practices] Act which requires, in a case where the misleading or deceptive conduct involves a misrepresentation, that the person who alleges damage must rely upon that misrepresentation. … All that is necessary, in our opinion, is that there be a sufficient and direct link (ie causation) between the loss or damage alleged to have been suffered by the claimant and the misleading or deceptive conduct.[41]

Citing these and other cases, Dorajay submitted that, under each of the statutory provisions relevant in the *Aristocrat* proceedings,[42] the necessary causal connection may arise because of reliance on the contravening conduct by a third party or a class of third parties. It went on, however, to say that to focus on

35 *Janssen-Cilag Pty Ltd v Pfizer Pty Ltd* (1992) 37 FCR 526 ('*Janssen-Cilag'*).
36 (1998) 196 CLR 494.
37 *Janssen-Cilag* (1992) 37 FCR 526, 529.
38 Ibid 530–1.
39 (2000) ATPR ¶41–737.
40 [1999] FCA 784 (Unreported, Hill, Sackville, Katz JJ, 11 June 1999) ('*McCarthy*').
41 Ibid [48].
42 *Corporations Act* ss 1005, 1041I and 1317HA (s 1005 was the predecessor to s 1041I); *ASIC Act* s 12GF; and *Trade Practices Act* s 82.

reliance risks obscuring the focus of the statutory inquiry and that the reason why it was not necessary to prove individual reliance in cases like *Janssen-Cilag* is that the misleading conduct had caused others to act to the direct prejudice of the plaintiff. In that context, the requisite causal connection between the contravening conduct and the loss was sufficiently established because the conduct 'by its very nature, causes the plaintiff's loss'.[43]

In applying this principle to the facts in issue, Dorajay relied upon the fact that the economic experts from both sides agreed that Aristocrat's shares were traded on an active secondary market which responded quickly to publicly available information (making the market for Aristocrat shares a 'semi-strong' form efficient market). It submitted that Aristocrat's alleged misstatements and omissions distorted that information and, as a result, the shares traded at prices higher than the price would have been if the information had not been distorted. In these circumstances, a person who acquired interests in shares in that inflated market, and who still held the shares at the time corrective information was released and the inflation removed, suffered loss. As Dorajay put it: 'They had paid too much to acquire the shares and they never recover that overpayment, regardless of whether or when they subsequently sold those shares.'[44]

In other words, on Dorajay's submission, the requirement for causation is satisfied by the simple fact that 'inflation did exist and the contravening conduct was a material cause of the inflation'.[45] Put in the language of the authorities, Aristocrat's conduct 'by its very nature'[46] caused the loss because it was a material cause of the inflation in the share price.

Although, at first glance, Dorajay's indirect approach to causation appears to be an iteration of the fraud-on-the-market theory expressed in terms of Australian legal concepts, there is at least one important difference. As mentioned above, the fraud-on-the-market theory creates a rebuttable presumption of reliance on the integrity of the market price to provide the necessary causal link between the contravening conduct and a claimant's loss. Dorajay's indirect approach to causation, however, means that reliance is irrelevant (not presumed) and does not provide an opportunity to rebut causation even if it could be established that the shareholder did not rely on the contravening conduct nor the integrity of the market price in making the decision to purchase Aristocrat shares. Consistent with that approach, Dorajay did not make a submission that the fraud-on-the-market theory should be adopted in Australia.

43 Dorajay's written submissions, above n 33, [425], citing *Digi-Tech (Australia) v Brand* (2004) 62 IPR 184, 212 ('*Digi-Tech*'); *Ford Motor Co of Australia Limited v Arrowcrest Group Pty Limited* (2003) 134 FCR 522, 539; *HIH Insurance Limited (in liq) v Adler* [2007] NSWSC 633 (Unreported, Einstein J, 22 June 2007) [68].

44 Dorajay's written submissions, above n 33, [422].

45 Ibid [428].

46 *Digi-Tech* (2004) 62 IPR 184, [155].

B The Case for Direct Causation

In making the case for a direct approach to causation, Aristocrat did not take issue with many aspects of the submissions made for an indirect approach to causation on behalf of Dorajay. In particular, it did not dispute the proposition that the relevant statutory provisions do not require reliance to be established, but rather require causation to be established. Nor did it dispute that, in some circumstances, it may not be necessary for a claimant to establish that it relied on the contravening conduct to establish causation.[47]

The key difference between the parties was the identification of the cause of Dorajay's alleged loss. Aristocrat submitted that Dorajay's loss was caused by it entering into commercial transactions to purchase Aristocrat shares. Dorajay's position was that its loss was caused by the price for Aristocrat shares being artificially inflated.

Aristocrat's central submission was that the inflation in its share price may have created an opportunity for Dorajay to suffer a loss, but that Dorajay had no exposure to that loss until it entered into a transaction to purchase Aristocrat shares. It follows that Dorajay's loss was not the 'natural and direct result' of Aristocrat's conduct. In those circumstances, to establish an entitlement to damages, it submitted that Dorajay should prove that it purchased shares in reliance on the alleged contravening conduct.[48]

Aristocrat submitted that acceptance of Dorajay's contention that, because the contravening conduct caused the share price to be inflated, the conduct therefore caused the loss, required acceptance of the proposition that a 'but for' approach to causation is sufficient. That, however, has never been the relevant test. Nor would it be sufficient for Dorajay to establish that Aristocrat's conduct provided the opportunity for it to incur a loss or that Aristocrat's conduct materially increased the risk that Dorajay would suffer loss.[49]

Aristocrat relied upon the line of authority (discussed below) which establishes that, where a claimant enters into a commercial transaction and suffers loss as a result, it is necessary to prove that the contravening conduct was a cause of the decision to enter into the transaction. That is, that the claimant either relied upon, or was induced by, the contravening conduct in making the decision to enter into the transaction.

Particular reliance was placed on the decision of the NSW Court of Appeal in *Digi-Tech (Australia) Ltd v Brand.*[50] In that case, the appellants sought to recover damages against Digi-Tech under section 82 of the *TPA* on the basis that Digi-Tech had produced misleading forecasts concerning revenue and gross margin in relation to certain products which had been relied upon by a third party in producing a valuation which supported a particular price for the rights to the products. Absent that valuation, the scheme by which the appellants invested in

47 Aristocrat's written submissions (SG Finch SC, MJ Darke, R Scruby), 29 October 2007, [125].
48 Ibid [126].
49 Ibid [127].
50 (2004) 62 IPR 184.

the products would not have been proposed and the appellants would not have suffered loss. The appellant's argument was described as the 'indirect causation theory' and was heavily reliant on the line of authorities beginning with *Janssen-Cilag*.

In rejecting the appellant's argument, the Court of Appeal acknowledged that, assuming Digi-Tech's forecast was misleading and deceptive, that conduct resulted in the production of a misleading and deceptive valuation and that the valuation enabled the investment scheme to be put together and proposed to the appellants. The Court went on, however, to say that:

> But to complete the chain of causation, there must be something linking the appellants' loss to their entry into the investment scheme. That link is the inducement of the appellants and their consequential act of entering into the transaction to their prejudice. Without that link, there is no proof that the misleading conduct caused the loss.
>
> Persons who claim damages under s.82(1) on the ground that they entered into transactions induced by the misrepresentations of other persons must prove that they relied on such misrepresentations and, therefore, 'by' that conduct, they suffered loss or damage.[51]

In Aristocrat's submission, the situation considered by the Court of Appeal in *Digi-Tech* was precisely Dorajay's situation. The damage for which it sought compensation flowed from it entering into transactions to buy shares in Aristocrat. In those circumstances, to recover compensation, it must show that it relied on Aristocrat's statements to the market in entering into those transactions.[52]

Aristocrat also pointed to the fact that McDougall J applied this aspect of *Digi-Tech* in the first instance decision in *Ingot Capital Investments v Macquarie Equity Capital Markets*[53] when his Honour said the following in respect of Justice Lockhart's reasons in *Janssen-Cilag*:

> His Honour's observations are not authority for the proposition that indirect causation is available (or that the test of causation in s.82 is satisfied by indirect causation) where it is alleged that a misrepresentation induced entry into a transaction.[54]

Aristocrat submitted that cases such as *Janssen-Cilag* in which reliance or inducement was not necessary to establish causation were far removed from the facts at issue in the *Aristocrat* case. It was unnecessary to prove reliance or inducement in *Janssen-Cilag* because 'the misleading conduct had caused others to act to the direct prejudice of the plaintiff'[55] (that is, by inducing them to purchase a rival's product). In that case, the requisite link between the defendant's misleading conduct and the plaintiff's loss was complete, absent inducement of the plaintiff, because the third party representee's act of purchasing the rival's product 'by its very nature, causes the plaintiff's loss'. In

51 Ibid [158]–[159].
52 Aristocrat's written submissions, above n 47, [142].
53 (2007) 63 ACSR 1. This decision was upheld on appeal as discussed below.
54 Ibid 134–5; Aristocrat's written submissions, above n 47, [143].
55 *Digi-Tech* (2004) 62 IPR 184, [155].

other words, *Janssen-Cilag* was a case where, without any act by the plaintiff, the plaintiff was caused loss.[56]

Aristocrat claimed that Dorajay's loss was not, however, caused simply by the fact that the price of Aristocrat shares was inflated and that this was not a case in which Aristocrat's conduct, by its very nature, caused Dorajay's loss. In those circumstances, reliance by, or inducement of, Dorajay was essential to establish causation. So much, Aristocrat said, was made clear by Wilson J in *Gould v Vaggelas* when his Honour said that '[n]otwithstanding that a representation is both false and fraudulent, if the representee does not rely upon it he has no case'.[57]

VI DEVELOPMENTS AFTER THE *ARISTOCRAT* TRIAL

There have been two developments since the *Aristocrat* trial in October 2007.

A The Court of Appeal's Decision in *Ingot Capital*

In December 2008, the NSW Court of Appeal handed down its decision in *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd*.[58] As mentioned above, Aristocrat relied upon the first instance decision of McDougall J in *Ingot Capital* in support of its case for a direct approach to causation.

Ingot Capital involved (among other things) a claim for damages in relation to an allegedly misleading and deceptive prospectus issued in 1999. The claim was made under sections 995 and 1005 of the *Corporations Law* (the predecessors to sections 1041H and 1041I of the *Corporations Act*).

The majority of the Court (Giles and Ipps JJA) affirmed and applied the decision in *Digi-Tech* and distinguished cases such as *Janssen-Cilag*. In doing so, Giles JA said that:

> Where there is a decision by the plaintiff whether or not to enter into a transaction, any resulting loss or damage is not dictated by the laws of nature… If the plaintiff would not have had the opportunity to enter into the transaction, that 'but for' element does not go beyond a reason why the plaintiff entered into it. Conduct which merely provides the opportunity for the plaintiff to enter into the transaction will not suffice, unless the purpose of ss 995 and 1005 is to provide recompense for loss or damage suffered only because there was the opportunity to enter into the transaction and without regard to materiality of the representation to the plaintiff's decision to enter into the transaction.
>
> …
>
> Section 1005 should be applied in a way that promotes provision of correct information to investors and protects them in making investment decisions. But this does not warrant compensating investors regardless of the effect on their decision-making of the misleading conduct.[59]

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56 Aristocrat's written submissions, above n 47, [145].

57 (1985) 157 CLR 215, 236; Aristocrat's written submissions, above n 47, [146].

58 (2008) 252 ALR 659 ('*Ingot Capital*').

59 Ibid 669.

Justice Hodgson said that he did not consider that investors would need to prove that 'they themselves' relied on and were misled by the misleading conduct, except possibly to the extent of showing that they did not know the truth concealed by the misleading conduct. His Honour went on to say that the position was at least arguable, but that it was not necessary for him to express a final view nor to state whether his thinking was consistent with *Digi-Tech*.[60]

Despite Justice Hodgson's reservations, it is clear that the Court of Appeal's decision in *Ingot Capital* supports the submissions made on behalf of Aristocrat in favour of a direct approach to causation in securities claims.

B The CAMAC Report

In January 2009, the Corporations and Markets Advisory Committee ('CAMAC') released its report entitled 'Shareholder Claims Against Insolvent Companies: Implications of the Sons of Gwalia Decision'.[61]

In *Sons of Gwalia Ltd v Margaretic*,[62] the High Court held that a shareholder who claimed that they were misled in the course of acquiring shares in a company through misrepresentation or defective market disclosure did not make that claim in their capacity as a member of the company. The effect of this decision is that shareholder claims of this nature can rank equally with the claims of unsecured creditors in proving in the winding up of a company.

Against this background, CAMAC considered (among other things) whether a fraud-on-the-market approach to causation should be introduced into Australian law through legislation as a possible way to facilitate proof of shareholder claims against insolvent companies. CAMAC concluded that it would be inappropriate to implement that approach in the limited context of shareholder claims against insolvent companies and that any consideration of whether to introduce the concept in a broader context would require careful analysis beyond the scope of its review. [63]

Although unlikely to have any influence on the courts, this conclusion (together with the explanation of the concepts of causation and reliance in the shareholder class action context in the report) suggests that the members of CAMAC do not consider a fraud-on-the-market style approach to causation to be available under the current law.

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60 Ibid 679.

61 Corporations and Markets Advisory Committee, *Shareholder Claims Against Insolvent Companies: Implications of the Sons of Gwalia Decision*, Report (December 2008).

62 (2007) 231 CLR 160.

63 CAMAC, above n 61, 81–4. The report did, however, note (at 83) that the fraud-on-the-market concept had, in effect, been adopted for the purposes of the settlement arrangement reached between ASIC and Multiplex Limited under which Multiplex, without admitting a contravention, undertook to compensate all persons who acquired securities during a particular period without the need for those persons to establish any form of reliance on the company's conduct.

VII HOW SHOULD THE ISSUE BE RESOLVED?

In our opinion, there are a number of compelling reasons, both as a matter of law and a matter of policy, as to why the courts should require a direct causation approach.

We accept that there is something intuitively appealing in the submission that, although it was the decision to purchase shares which ultimately exposed Dorajay to its loss, it was the inflation in the share price which caused the loss.

However, that submission does not, in our opinion, stand up to scrutiny when considered in the context of the authorities and relevant policy considerations. The weight of Australian authority supports a direct causation approach. Further, an indirect causation approach would result in recovery by claimants who did not rely on the contravening conduct nor the integrity of the market price – a result which the courts have repeatedly said is at odds with the policy objectives of the legislation and cannot be countenanced. Finally, an indirect approach to causation is dependent on a finding that the market for the security in question is efficient which, in turn, raises further questions and potential complications. Each of these reasons is elaborated upon in the sections below.

A The Authorities

As mentioned above, the decisions of the NSW Court of Appeal in *Digi-Tech* and *Ingot Capital* are authority for the proposition that an indirect causation approach (such as was applied in *Janssen-Cilag*) is not to be applied in circumstances in which it was necessary for the claimant to take some form of action (such as to enter into a transaction) to expose itself to the loss.

Further, there is no authority to support an indirect causation approach in circumstances in which it was necessary for the claimant to take action to expose itself to the loss. The authorities supporting an indirect approach (such as *Janssen-Cilag*) do so only in circumstances in which the loss is the 'natural and direct result' of the contravening conduct.

In these circumstances, the adoption of an indirect causation approach in securities class actions would require a court to determine that securities claims are a special category of claims to which a special rule should be applied. This would, in effect, introduce a version of the fraud-on-the-market theory into Australian law (irrespective of whether the mechanics of that rule presume reliance or bypass reliance altogether). In our opinion, if this approach is to be adopted, it is a matter for legislative reform.[64]

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64 Incidentally, White J in his dissenting opinion in *Basic* considered that the fraud-on-the-market theory constituted such a fundamental change to the reliance requirement that it should come expressly from Congress rather than the courts (485 US 224 (1988), 253–4). There are also a number of examples of provincial legislatures in Canada responding to not dissimilar circumstances through the establishment of a statutory presumption of reliance in relation to certain forms of disclosure documents following rejection of an indirect approach to causation by the courts (see, eg, ss 130 and 131 of the *Securities Act, R.S.O* 1990 (Ontario)).

B Recovery by Investors Who Did Not Rely on the Contravening Conduct or the Integrity of the Market Price

An approach to causation that allows the recovery of loss by investors who did not rely on the contravening conduct nor the integrity of the market price does not achieve the objectives of the relevant statutory provisions and has, accordingly, been rejected by the courts.

For example, the NSW Court of Appeal in *Digi-Tech* said:

> Persons who claim damages under s 82(1) on the ground that they entered into transactions induced by the misrepresentations of other persons must show that they relied on such misrepresentations and, therefore, 'by' that conduct, they suffered loss or damage. As Mr Sheahan pointed out, were it otherwise, representees could succeed even though they knew the truth, or were indifferent to the subject matter of the representation.[65]

This sentiment was repeated by Giles JA in *Ingot Capital* when his Honour said:

> As was pointed out in *Digi-Tech (Australia) Pty Ltd v Brand* at [159], ss 995 and 1005 should not be given a scope whereby an investor entering into a transaction could recover even if it knew the truth of the underlying misrepresentation, or was indifferent to its truth, and proceed nonetheless.[66]

Although Hodgson JA in *Ingot Capital* indicated that he considered an indirect approach to causation to be 'arguable', his Honour said that was only in circumstances in which 'the investors did not know the truth'.[67] On this basis, it seems clear that his Honour would not have accepted Dorajay's indirect causation approach which allowed no opportunity for rebuttal of an individual claimant's case for causation.

Whether or not Dorajay relied on the contravening conduct and/or the integrity of the market price was a key issue in the *Aristocrat* trial. Aristocrat submitted that Dorajay was an investor which was indifferent to the truth of Aristocrat's representations as to its financial performance and that, in those circumstances, it should not be entitled to recover its loss arising from the purchase of shares at an inflated price. That was because, in Aristocrat's submission, the evidence adduced at trial established that Dorajay traded in Aristocrat shares with a view to making short term profits by taking advantage of volatility in the share price.[68] This submission was supported by the evidence given by the principal of Dorajay who accepted during cross-examination that, in short term trading of this nature, what is important is the movement in the share price during the time the trade is open and not the information which is said to be reflected in the share price (such as the preceding year's profit announcement).[69] In other words, in this sort of trading activity (often called 'day trading'), the

65 *Digi-Tech* (2004) 62 IPR 184, 212.
66 *Ingot Capital* (2008) 252 ALR 659, 670.
67 Ibid 679.
68 Aristocrat's written submissions, above n 47, [148]–[154].
69 Transcript of Proceedings, *Aristocrat* (Federal Court of Australia, 11 October 2007), 301.

fundamentals of a company's financial position are irrelevant. So too is the relationship between those fundamentals and the company's share price.[70]

For those reasons, Aristocrat submitted that Dorajay was indifferent to whether or not Aristocrat shares represented value for money having regard to the underlying fundamentals of the company. Even though Dorajay may have purchased shares at an inflated price, any loss was not caused by Aristocrat's conduct because Dorajay had no interest in what that price represented, including whether or not it was inflated. In these circumstances, it could not be said that Dorajay's loss was caused by Aristocrat's conduct.[71]

Day traders are not the only category of investors who do not necessarily rely on information released by the company. Potential claimants in securities class actions range from unsophisticated retail investors to sophisticated and well-advised institutional investors. Depending on their interests, understanding, available time and approach to trading (among other things), different types of investors may take into account many different matters in making decisions to transact – some related to or dependent upon the information released by the company or the integrity of the market price, some not.[72]

An institution or other sophisticated investor may, for example, take into account a wide range of information in making investment decisions. This information is likely to include information released by the company, but may also include independent research and advice that has been prepared in order to form a view as to the company's performance or expected performance, which is separate from the information released by the company. If investment decisions are made on the basis of that independent research and advice, there are good policy reasons, in our opinion, why those circumstances should properly be examined by the court.

Further, some institutional funds are structured to mirror a particular trading index (such as, for example, the ASX 200) and decisions to buy and sell securities are based solely on the movements in and/or weighting of the index without reference to information released by a particular company. Adopting a different approach, chartists make transaction decisions by reference to predicted future price movements based on what they consider to be recurring securities trading patterns. Neither of these approaches rely upon information released by the company or the integrity of the market price.

The fact that the circumstances and matters affecting investors' decisions to transact are so varied highlights the fact that a 'one size fits all' indirect approach to causation will result in recovery by investors who did not rely on the contravening conduct nor the integrity of the market price. A direct approach to causation, on the other hand, enables a court to examine the different circumstances in which different categories of investors entered into the relevant transactions and make a decision as to whether or not their loss was caused by

70 Aristocrat's written submissions, above n 47, [149].
71 Ibid [148]–[154].
72 See, eg, the discussion by Ashley Black in the Hon Justice K E Lindgren (ed), above n 29, 105–6.

the contravening conduct and whether the investor is properly entitled to recover any loss.

C The Necessity for an Efficient Market

All versions of an indirect approach to causation in the securities claim context are based on the fundamental assumption that the market for the relevant security is efficient (or at least 'semi-strong form' efficient). As mentioned above, 'semi-strong form' efficiency requires that new publicly available information is quickly and accurately incorporated into the relevant security's price so that that price accurately reflects the effects of the contravening conduct in question at all relevant times.

In our view, the requirement for a semi-strong form efficient market gives rise to at least the following issues:

- There is nothing in the relevant statutory provisions or authorities that supports an approach to causation which treats purchasers of securities in efficient capital markets differently to the purchasers of securities in inefficient markets.[73]
- The economic theory behind the efficient markets hypothesis has come under increasing scrutiny and criticism in recent years. Few economists now believe that the hypothesis holds true in practice and there is a considerable volume of research in the field of behavioural finance that demonstrates anomalies and the irrationality of public markets.[74] Further, Australian courts have never accepted the validity of the hypothesis and have, to the contrary, accepted that market behaviour can be 'skittish' and 'unpredictable'.[75]
- Assuming for a moment the validity of the efficient capital markets hypothesis, before a court could apply an indirect approach to causation, it would need to be satisfied as to the efficiency of the relevant market. In *Aristocrat*, the economic experts for both parties agreed that the market for Aristocrat shares was 'semi-strong' form efficient. In those circumstances, it is unlikely that the issue would have caused the Court too many difficulties. It is, however, conceivable (and indeed likely) that there will be cases in which the respective experts will have differing opinions as to whether or not the market for the relevant stock is sufficiently efficient for an indirect approach to causation to be applied. In these circumstances, it will be necessary for the court to determine the issue.

73 Aristocrat's written submissions, above n 47, [128].
74 See, eg, Ferrillo, Dunbar and Tabak, above n 25, 107.
75 See, eg, *ASIC v Southcorp Limited (No 2)* (2003) 203 ALR 627, 638.

VIII CONCLUSION

There are several major securities class actions before the Federal Court at present where an indirect causation approach is pleaded on behalf of group members.[76] Resolution of the appropriate approach to causation will be critical in those cases.

It is our opinion that the indirect causation approach is not available for securities claims in Australia having regard to the way which in the relevant statutory provisions have been interpreted. In these circumstances, it could only introduced through legislative intervention and there are good policy reasons why that should not occur. So far as we are aware, a legislative response is not currently under formal consideration.

76 Including, eg, the class actions commenced against Multiplex, AWB and the Centro Group.