Shareholder class actions – the causation debate

Stephen O'Dowd, Harbour's Senior Director of Litigation Funding, considers the ongoing causation debate in this rapidly evolving area.

It is difficult to establish a shareholder claim in any jurisdiction. Outside of the US, there are additional challenges, owing to a paucity of judicial guidance. Of these additional challenges, causation is arguably the most significant.

At the heart of the causation challenge is the issue of reliance. A public company may be liable for breach of its continuous disclosure obligations because it made misleading statements to its market. However, an investor who acquired shares that were overvalued due to the company's misconduct might have no remedy, because he cannot show that he relied on the company's misconduct when making his investment decision.

Establishing individual reliance in this way can be problematic, especially in a class action where the class comprises hundreds or thousands of investor members. One answer to the problem is to adopt the theory of an efficient market when determining causation. Such a theory is based on the premise that the share price of a public company reflects all known, relevant information about that company.

In the context of a shareholder action, efficient market theory renders the question of reliance by individual investors moot, save where it can be shown that an investor was indifferent to actual knowledge he had about the misconduct of the company he invested in.

The US courts have firmly adopted efficient market theory in relation to questions of causation in shareholder actions. That position was recently reaffirmed by the US Supreme Court in Halliburton *Co. v Erica P. John Fund, Inc.* However, the position is less certain in other jurisdictions.

In Australia, which enjoys a similarly well-developed class-action regime to the US, there is an ongoing debate about causation and reliance in relation to shareholder class actions. Class members will typically argue for efficient market theory, and defendants will argue for individual reliance. These arguments are left unresolved because the vast majority of such claims settle. As a result, new claims lead with an applicant who can establish individual reliance just in case the courts refuse to adopt efficient market theory.

Recent Australian decisions suggest that the causation debate is likely to be settled in favour of claimants. In *Caason* Investments, the Full Federal Court granted leave to the claimants to plead efficient market theory, and in *HIH Insurance Limited (in liquidation)*, the Supreme Court of New South Wales actually adopted the theory.

Pro-defence commentators in Australia have been quick to point out that Caason is not determinative and that HIH is merely the first instance decision of a single judge. In short, the debate will continue until such time as Australia's High Court delivers its verdict.

Until then, aggrieved investors in Australia, and in other jurisdictions, must continue to navigate uncertainty over the correct approach to causation. But with claims in this area rapidly evolving, we should expect more certainty in short order.

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