

**THE REFORM OF  
MISSTATEMENT LIABILITY  
IN AUSTRALIA'S PROSPECTUS LAWS**

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**DISSERTATION**

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### ***Synopsis***

*This dissertation considers the reforms made to the liability rules in Australia's prospectus laws during the 1990s. It traces the rewrite of the fundraising provisions at the end of the 1980s as part of the new Corporations Law through to the rewrite of those provisions at the end of the 1990s as part of the CLERP Act initiative.*

*As the law in this area is not particularly well served by detailed judicial or academic analysis in Australia, the dissertation seeks to define the scope of the Australian liability regime by reference to case law analysis, a review of relevant theoretical considerations and comparative analysis with other key jurisdictions.*

*The thesis of the dissertation is that many of the reforms were, particularly initially, misconceived in key respects because of a failure to apply appropriate theoretical underpinnings and to take account of the lessons that could have been learned from a comparative analysis with other key jurisdictions.*

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## CERTAIN DEFINED TERMS USED IN THIS DISSERTATION

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<b><i>1867 Material Contracts Act</i></b>	Section 38, <i>Companies Act</i> 1867 (England) 30 & 31 Vict c 131
<b><i>1890 Directors Liability Act</i></b>	<i>Directors Liability Act</i> 1890 (England) 53 & 54 Vict c 64
<b><i>ALI Federal Code</i></b>	American Law Institute “ <i>Federal Securities Code with Reporters Comments</i> ” (1980 American Law Institute)
<b><i>ASIC</i></b>	Australian Securities and Investments Commission
<b><i>ASX</i></b>	Australian Stock Exchange Limited
<b><i>BarChris Case</i></b>	<i>Escott et al v BarChris Construction Corporation et al</i> 283 F Supp 643 (SDNY 1968)
<b><i>Corporations Act or CA</i></b>	The <i>Corporations Act</i> 2001
<b><i>Corporations Law or CL</i></b>	The Corporations Law of each Australian State and the <i>Corporations Act</i> 1990 (ACT), as it existed prior to the <i>Corporations Act</i> 2001
<b><i>CLERP Act</i></b>	<i>Corporate Law Economic Reform Act</i> 1989 (No. 156 of 1999)
<b><i>CLERP Fundraising Paper</i></b>	CLERP Proposals for Reform: Paper No. 2 “ <i>Fundraising Capital Raising Initiatives to Build Enterprise and Employment</i> ” (1997, Treasury)
<b><i>Feit Case</i></b>	<i>Feit v Leasco Data Processing Equipment Corporation et al</i> 332 F Supp 544 (EDNY 1971)
<b><i>Lonergan Committee Report</i></b>	Companies and Securities Advisory Committee Prospectus Law Reform Sub-committee Report (March 1992, AGPS)
<b><i>Misleading &amp; Deceptive Conduct Provisions</i></b>	The statutory civil remedies for misleading and deceptive conduct described in Part 5.1
<b><i>Pre-CLERP Corporations Law</i></b>	The <i>Corporations Law</i> before the enactment of the <i>CLERP Act</i>
<b><i>Simplification Task Force</i></b>	Simplification Task Force established by the Attorney General’s Department in 1993
<b><i>Simplification Task Force Paper on Fundraising</i></b>	Corporations Law Simplification Program “ <i>Fundraising: Trade Practices Act, s.52 and Securities Dealings</i> ” Task Force, November 1995 (Attorney General’s Department, AGPS)

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## CHAPTER 1

### BACKGROUND TO THE DEBATE

#### 1.1 INTRODUCTION TO DISSERTATION

This dissertation considers the reforms to the liability regime applicable to Australia's prospectus laws in the late 1980s and during the 1990s. Those reforms were intended to improve the effectiveness of the liability regime contained in Australia's prospectus laws which, at the end of the 1980s, was generally perceived to be poorly drafted and ineffectual. The prospectus laws were the target of special attention at that time and were the only significant part of the Australian corporations and securities legislation to be fundamentally rewritten as part of the enactment of the *Corporations Law* implemented with effect from 1 January 1991.

The regulatory provisions were again completely rewritten by the *CLERP Act* on 13 March 2000 and incorporated in that form into the restated *Corporations Act* from 15 July 2001.<sup>1</sup>

As such, in the space of a decade, the prospectus laws of Australia have been entirely restated twice. This is against a background where the scope of the provisions, particularly the liability rules, had not been significantly altered in the preceding century.

The reforms of the early 1990s resulted in great anxiety in the business and legal community and a perception that Australia's securities laws had entered a new phase of greatly enhanced exposure for companies and their advisers involved in the capital raising process.<sup>2</sup> This dissertation tests that proposition.

As the law relating to prospectus liability is not well served by detailed academic or judicial analysis in Australia, this dissertation seeks to define the scope of the liability regime. In

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<sup>1</sup> The *Corporations Act* finally achieved the long debated goal of the Australian corporations and securities law being a federal piece of legislation, rather than state legislation (as had been the case with the *Corporations Law*).

The *Corporations Act* reflected the culmination of the ongoing constitutional debate that started with the striking down of the original proposed federal legislation through the High Court decision of *NSW v Commonwealth* (1990) 169 CLR 482, the subsequent sub-optimal cross-vesting of state legislation as reflected in the weaknesses exposed through the High Court decision in *Re Wakim; Ex parte McNally* (1999) 198 CLR 511, through to the ultimate referral of constitutional power by the states to the Commonwealth to create the *Corporations Act* in 2000.

The enactment of the *Corporations Act* in 2000 did not involve any changes to the regulatory provisions applicable to prospectuses.

<sup>2</sup> The mood of the time is demonstrated by materials such as J. Steven "Fundraising: Advisers in the Hot Seat" (1988) 13 Butterworths Company Law Bulletin para 299; S. Walker "Underwriters Liability: Upping the Ante in the 1990's" (1989) 11 Legal Issues 10; N.O'Bryan & R. Austin "Capital-Raising Under the Corporations Act" (Jan 1990) Law Institute Jnl 61 at 67-8; S. Weeraratna "Civil Liability and Due Diligence" (September 1991) Law Inst Jnl 854; G. McGrath "Underwriters Can't be Overcareful" [1992] Vol 4 JASSA 7.

addition, this dissertation seeks to assess the effectiveness of the reform proposals by reference to relevant theoretical policy considerations.

This chapter provides a review of the regulatory history of the prospectus liability provisions in Australia and in other key jurisdictions. This chapter also assesses the place of sanctions for prospectus misstatement in the context of relevant policy considerations applicable to the fundraising process. Chapters 2, 3, 4, 5 and 6 provide an analysis of the liability regime and its relationship to the mandatory disclosure regime for prospectuses imposed by Chapter 6D of the *Corporations Act*. Chapters 7, 8, 9 and 10 deal with the position of the various participants involved in the capital raising process, as well as the position among themselves. Chapter 11 is a short conclusion.

The thesis of this dissertation is that many of the initial reforms were misconceived and largely ineffective because of a failure to comprehend relevant theoretical underpinnings, the deficiencies identified with previous legislation and the lessons that could be learned from a comparative analysis with the securities laws in other key jurisdictions.

This dissertation also examines the extent to which the 2000 *CLERP Act* amendments represent an improvement in the regulatory scheme.

This dissertation is based generally on the law in Australia as at 31 December 2001.

## 1.2 OVERVIEW OF THE CORPORATIONS ACT PROVISIONS

Liability for prospectus misstatement is now dealt with in Part 6D.3 of the *Corporations Act*. Part 6D.3 replaced parts of Part 7.11 of the original *Corporations Law* with the enactment of the *CLERP Act* in March 2000.

The provisions of the *Corporations Act* dealing with the offering of securities and prospectus lodgement are contained in Chapter 6D of the *Corporations Act*. Chapter 6D replaced part 7.12 of the original *Corporations Law* with the enactment of the *CLERP Act*.

The broad structure of the legislation as it gives rise to the potential of liability for prospectus misstatement can be simply summarised as follows:

- The *Corporations Act* provides that it is an offence to make an offer of securities or distribute an application form for an offer of securities that needs disclosure to investors

unless the disclosure document for the offer has been lodged with ASIC.<sup>3</sup> No applications can be accepted for a period of 7 days after lodgement of the disclosure document with ASIC.<sup>4</sup> The offers that need disclosure to investors are offers of securities for issue<sup>5</sup> and some offers of securities for sale.<sup>6</sup> Pre-prospectus advertising of the availability of securities or “gun jumping” is prohibited before a disclosure document is lodged with ASIC.<sup>7</sup>

- Certain offers of securities do not need disclosure under Chapter 6D, such as offers to sophisticated investors, offers to professional investors and a residual right to make small scale offerings of no more than 20 issues in any 12 month period to raise no more than \$2 million.<sup>8</sup>
- Four types of disclosure document are contemplated by the legislation - prospectuses, special prospectuses for continuously quoted securities, offer information statements and profile statements.<sup>9</sup> The general prospectus standard of disclosure is all information that investors and their professional advisors would reasonably require to make an informed assessment of the assets and liabilities, financial position and performance, profits and losses and prospects of the issuer.<sup>10</sup> If the securities are securities quoted on the ASX or options to acquire those securities, an alternative lower threshold applies requiring disclosure of all information investors and their professional advisors would reasonably require to make an informed assessment of the effect of the offer on the issuer.<sup>11</sup> If the

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<sup>3</sup> CA section 727(1). The obligation to lodge a disclosure document arises under CA section 718.

<sup>4</sup> CA section 727(3). The period may be extended by ASIC to up to no more than 14 days after lodgement.

<sup>5</sup> CA section 706 - being the initial issue of securities.

<sup>6</sup> CA section 707 - being the following forms of secondary sales:

- an offer by a person controlling an issuer where the securities are not quoted or if quoted they are not offered in the ordinary course of trading on a stock market (section 707(2));
- an offer within 12 months after their issue if not offered under a disclosure document (or sale if sold by a controlling person) for the purpose of the person to whom they were issued (or sold) onselling them (section 707(3) - (6)).

<sup>7</sup> CA Section 734.

<sup>8</sup> CA section 708 - as each of those exemptions are defined in that section.

<sup>9</sup> CA section 709.

<sup>10</sup> CA section 710. The prospectus must also include the specific disclosures required by CA section 711. There are no detailed disclosure requirements in the legislation as to the description of matters such as the business of the issuer or the financial position of the issuer. Information can be incorporated by reference in certain circumstances - CA section 712.

<sup>11</sup> CA section 713. Certain specific disclosures about the availability of previously disclosed information must also be made - CA section 713(3) and (4).

issuer is raising \$5 million or less (in addition to all amounts previously raised) an offer information statement can instead be used which merely requires the inclusion of recent audited financial statements and the disclosure of certain basic information.<sup>12</sup> Profile statements can be used for various forms of retail investment products which provide for abbreviated disclosure in the profile statement, although this does not obviate the need to lodge a full prospectus with ASIC.<sup>13</sup>

- The directors and proposed directors of the issuer must consent to the issue of the disclosure document<sup>14</sup> and where a statement is made by a person or a statement in the document is based on a statement made by a person that person must also consent to that statement being included.<sup>15</sup>
- A supplementary or replacement disclosure document is required if there is a misleading or deceptive statement or omission from the disclosure document or a new circumstance arises that would have required disclosure if it had arisen previously that is materially adverse from the point of view of an investor.<sup>16</sup>
- It is a criminal offence for a person to offer securities under a disclosure document if there is a misleading or deceptive statement in the disclosure document or an omission from the disclosure document of material required to be disclosed if it is materially adverse from the point of view of an investor.<sup>17</sup>
- A civil remedy is available to any person who suffers loss or damage because an offer of securities contravenes the previous prohibition, with certain specified persons primarily liable for that loss or damage.<sup>18</sup> The relevant limitation period is 6 years after the day on

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<sup>12</sup> CA section 709(4) and section 715.

<sup>13</sup> CA section 709(2) and section 714.

<sup>14</sup> CA section 720. For secondary sales the seller must consent.

<sup>15</sup> CA section 716(2).

<sup>16</sup> CA section 719.

<sup>17</sup> CA section 728(3). The same applies to a new circumstance that has arisen that would have required disclosure if it had arisen previously.

<sup>18</sup> CA section 729(1).

which the cause of action arose<sup>19</sup> and that remedy does not affect any liability a person has under any other law.<sup>20</sup>

- A person with potential liability under the above regime (criminal or civil) has a defence if they prove they made all enquiries that were reasonable in the circumstances and believed on reasonable grounds in the accuracy of disclosure<sup>21</sup> or they placed reasonable reliance on the information given to them by another person<sup>22</sup> (these two defences are described as the “*due diligence defences*” in this dissertation). In addition, in the case of certain specified persons, a defence is available if they publicly withdrew their consent to be named in the document.<sup>23</sup> In the case of an offer information statement or profile statement, lack of knowledge of the misleading or deceptive statement or omission is also a defence.<sup>24</sup>

This dissertation examines the liability consequences of “misstatements” in relation to capital raising. The term “misstatement” is intended to generally mean both:

- a statement that is misleading or deceptive (within the meaning of CA Section 728 (1)(a)); and
- an omission of information required to be disclosed in the disclosure document (within the meaning of CA Section 728(1)(b)).

### 1.3 A REPORT CARD ON THE AUSTRALIAN ENFORCEMENT RECORD

As the prospectus provisions of the Australian securities laws were the subject of special attention with the enactment of the *Corporations Law* in 1991, it is helpful to commence this dissertation with a short overview of the policy concerns that drove the regulatory agenda to introduce the *Corporations Law* and to contrast that debate with the Australian enforcement record in relation to prospectus misstatement, both historically and since the enactment of the current *Corporations Act* regime.

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<sup>19</sup> CA section 729(3).

<sup>20</sup> CA section 729(4).

<sup>21</sup> CA section 731.

<sup>22</sup> CA section 733(1).

<sup>23</sup> CA section 733(3).

<sup>24</sup> CA section 732.

### **Failings in the Australian system before the 1990s.**

Much space was devoted to perceived abuses of corporations and securities laws in the financial pages of Australian newspapers in the late 1980s and early 1990s following on from the entrepreneur fuelled stock market crash that took place in Australia at that time. This populist response was also reflected in the work of academics who specialised in the area of corporate crime at the time.<sup>25</sup>

Academic commentary in this area has been less fashionable at the end of the 1990s, although with the tech-wreck of 2000 and an upsurge in public commentary as to perceived shortcomings of the Australian corporations and securities laws in 2001 following a number of high profile corporate collapses, it can be expected that the debate will be revisited.

At the time of the enactment of the *Corporations Law*, the key themes emerging from the academic material as to the general deficiencies of the preceding corporations and securities laws can be summarised as follows.<sup>26</sup> The validity of these concerns will be tested in the prospectus context through this dissertation.

***Lack of Enforcement:*** Lack of enforcement of Australia's corporate laws was consistently presented as the key failing of securities regulation in the 1980s. The particular focus of criticism was the enforcement record of the predecessor regulatory body to ASIC (the National Companies & Securities Commission and the State Corporate Affairs Commissions). It will be clear from this dissertation that unenforced securities law causes problems as acute as poorly drafted securities laws.<sup>27</sup>

***Blurring of the Criminal/Civil Boundary:*** Many provisions of the Australian corporations and securities laws provide for both criminal and civil consequences for a contravention, with the same standard of culpability applied to both the criminal and civil offence. A good example of this feature is the prospectus misstatement laws themselves, as will be analysed in this dissertation.

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<sup>25</sup> The principal academics active in this area in Australia at that time were Messrs Fisse and Tomasic. As examples of the academic literature at the time see *Fisse & Braithwaite (1988)*; *Tomasic (1990)*; *Tomasic (1992)* and *Tomasic (1993)*.

<sup>26</sup> The following summary is based on the key themes emerging from the literature referred to in the preceding footnote.

<sup>27</sup> This criticism has also been made in the United States from time to time. It has been suggested that if a pattern of light sentences and isolated prosecutions exist, those involved in the market will consider that the risk of prosecution is an acceptable cost having regard to the potential rewards available from contravening the securities laws. See for example *Ogren (1973)* at 974 - 5.

Under this regime there is no clear spectrum of blameworthiness or condemnation reflecting the seriousness of a violation that might occur. It can be argued that where criminal liability is not based on an appropriate degree of blame, prosecutions may be difficult to achieve because of the seriousness of the consequences of a finding of guilt.

It is further argued that the failure of the criminal laws to deal with the alleged corporate criminal in circumstances where civil remedies are identical lead to difficulty in pursuing civil actions where the same facts may give rise to concurrent criminal consequences.

***Lax Values of Participants in the Securities Industry:*** Lax values of participants in the securities industry were identified as a major cause of difficulty in the 1980s. The Australian commentators suggested that phenomenon had the following characteristics.

- A corporate cowboy mentality - the public prominence of laissez faire entrepreneurs who used corporate law as a device to serve their own ends without regard to considerations of the policy underpinnings of the law or to moral considerations was suggested as a particular problem.<sup>28</sup>
- Business ethos - in addition to the phenomenon of the corporate cowboy mentality, it was argued that traditional business standards and morality failed to provide a countervailing force to the actions of the corporate cowboys. As such, it was argued that the business community countenanced the excesses of the “law-benders”.
- Professional indifference - the criticism was made that the professional advisers to the business community (lawyers, accountants and investment advisers) acted in an amoral way and assisted by facilitating “loopholing” of relevant statutory requirements. On this view the securities laws were seen as a tactical device to be circumvented, if possible, rather than a body of rules designed to identify the boundaries of acceptable corporate conduct.

After a decade of the *Corporations Law* and the *Corporations Act*, it must be asked whether these concerns were addressed in a meaningful way:

- has there been any improvement in the Australian enforcement record?

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<sup>28</sup> In other words, the attitude that if publicly admired figures could “get away” with morally offensive conduct that would influence similar conduct on the part of many persons.

- have the values of securities law participants improved?

### The Record on Prospectus Enforcement

Against the background of the general criticism of Australia's securities laws leading up to the enactment of the *Corporations Law*, it is also helpful to focus on the record in relation to prospectus misstatement enforcement, both in Australia historically and recently.

While prospectus laws have been a feature of most Australian jurisdictions since the turn of the 20th century, there is no meaningful judicial record of enforcement.

There are a number of early Australian cases dating from the turn of the twentieth century dealing with prospectus misstatement but in all relevant cases the actions were brought under the common law remedies of the tort of deceit or rescission, rather than under the statutory remedies that were being introduced at that time.<sup>29</sup> The dismal enforcement record reflected in that early case law demonstrates the limitations of common law remedies.<sup>30</sup> As such, the reported case law suggests that a legislative reaction to impose liability for prospectus misstatement would clearly have seemed appropriate from a policy perspective.

Since that time there has been very little case law consideration of the statutory liability regime.<sup>31</sup> That case law is not helpful to an appreciation of the nature of the liability imposed upon participants in the capital raising process or the defences that are available to them. A review of

<sup>29</sup> The cases are:

- *Bowman v Howman* (1862) 1 W&W (L) 390 (Vic) (deceit action - no misstatement)
- *Wright v Darwent* (1869) 3 SALR 121 (deceit action - no fraud)
- *Allan & Ors v Gotch* (1883) 9 VLR (L) 371 (deceit action - no misstatement)
- *Benjamin v Wymond* (1884) 10 VLR (Eq) 3 (promoter liability for misstatement established)
- *Ingham v Hardy* (1885) 19 SALR 64 (deceit action - no fraud or reliance)
- *Laugier v The Victorian Schanschieff Electric Light & Power Company Ltd* (1889) 16 VLR 64 (rescission action - no misstatement)
- *Whittlesea Land Company v Gutheil* (1892) 18 VLR 557 (rescission action - delay)
- *Percival Johnston v Friends Motor Co Ltd* (1910) 10 CLR 365 (rescission action - no reliance)
- *The Civil Service Corporative Society of Victoria Limited v Blyth & Ors* (1913) 17 CLR 601 (rescission action - delay and statement of intention)
- *North-West Co-operative Freezing Canning Co Ltd v Easton* (1915) 11 Tas LR 65 (rescission action - delay)
- *Grogan v The Astor Limited* (1925) 25 NSW 409 (rescission action - liability established)
- *Barrow v De Garis & Ors* (1926) 29 WAR 4 (deceit action - no reliance).

<sup>30</sup> Only in two of these reported cases was liability established (*Benjamin v Wymond* and *Grogan v The Astor*). Inevitably, the claims for compensation founded on technical difficulties associated with the common law remedies being pursued. For discussion of these issues see Section 5.3.

<sup>31</sup> The key cases are *Commonwealth Homes & Investment Company Limited v Smith* (1938) 59 CLR 443 (no rescission for breach of minimum subscription requirement of the *Companies Act*); *Montgomery v Stewart* (1967) 116 CLR 220 (criminal prosecution for prospectus misstatement - relates to the technical issue of whether a number of offences are created if there is more than one misstatement); *CAC (NSW) v Walker* (1987) 11 ACLR 884 (NSW Supreme Court) (prospectus misstatement under *Crimes Act*).

The notable exception is *Flavel v Giorgio* (1990) 2 ACSR 568 (SA Supreme Court, Full Court); (1989) 15 ACLR 486 (Prior J); (1988) 14 ACLR 123 (O'Loughlin J) (successful criminal prosecution).

the reported case law and academic material suggests that criminal prosecutions or civil actions have rarely been threatened or commenced for alleged prospectus misstatement.

Against such a poor historical record of enforcement it is helpful to set out the record concerning prospectus enforcement in the 10 years since the enactment of the *Corporations Law*.

The 1990s were marked by an increased level of capital raising activity in Australia to that of the late 1980s. During the 1990s ASIC received more than 8,000 prospectuses for registration:

**Table 1: Australian Prospectuses<sup>32</sup>**

<b>Period</b>	<b>Lodged</b>	<b>Registered</b>
1990/91	N/A	N/A
1991/92	991	636
1992/93	959	629
1993/94	1,226	786
1994/95	N/A	503
1995/96	N/A	466
1996/97	N/A	602
1997/98	N/A	683
1998/99	N/A	707
1999/2000	1,033	1,033
2000/2001	2,744	2,744
<b>Total:</b>		<b>8,789</b>

<sup>32</sup> Source: ASIC Annual Reports 1990/1 to 2000/1.

As at 31 December 2001, not one prosecution had been commenced by ASIC in relation to any of those prospectuses.

In the early 1990s, two high profile prosecutions were commenced against directors and advisors in relation to prospectuses that had been lodged in the late 1980s. Those prosecutions related to the prospectuses of White Constructions Limited and Budget Corporation Limited and were based on the predecessor companies legislation.

In the case of White Constructions Limited, a prosecution against the directors and investigating accountant was unsuccessful, the magistrate finding that there was no case to answer.<sup>33</sup> An application for judicial review of the decision of the magistrate was rejected on technical grounds.<sup>34</sup>

In the case of Budget Corporation Limited, the magistrate found that the solicitor and accountant involved in the prospectus had no case to answer in committal proceedings.<sup>35</sup> In the case of the prosecution against the directors the jury was discharged after being unable to reach a decision.<sup>36</sup>

Similarly a civil enforcement record for prospectus misstatement was completely lacking during the 1990s.<sup>37</sup>

The foregoing is not to suggest that ASIC was not active in relation to prospectus enforcement during the 1990s. First, the “stop order” power introduced by the *Corporations Law* proved an effective method for ASIC to pursue enforcement strategies where the view was formed by ASIC

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<sup>33</sup> *Australian Securities Commission v Burns & Ors* (unreported, 30 October 1992) (Magistrates Court, ACT).

<sup>34</sup> See *Australian Securities Commission v Burns & Ors* (1994) 12 ACLC 545 (FCA, Neaves J). The review related to a finding that the accountant could not be prosecuted under the then predecessor legislation to section 1041E of the *Corporations Act* for his involvement in the prospectus (section 999 (as it then was) clearly did not apply to the issue of securities). The application demonstrated a complete lack of knowledge by the prosecutor of the limitations of that legislation at the time - see the discussion of section 1041E at Section 5.2 below.

<sup>35</sup> *Cwth DPP v Stevenson & Smithers* (unreported 17 October 1994) (Local Court, Sydney). The case sought to impose accessory liability for a breach of the *Crimes Act*. For analysis see Section 9.4 below.

<sup>36</sup> The case was brought under the criminal liability provisions of the prior companies legislation. The jury failed to reach a verdict and were discharged after a lengthy trial in August 1997. The Director of Public Prosecutions subsequently elected not to proceed with a retrial.

<sup>37</sup> There were no civil actions commenced based on the civil liability regime.

However, see the prospectus cases based on section 52 of the *Trade Practices Act* in *Famel Pty Limited v Burswood Management Limited* (1989) ATPR 40-692 and *Morey v Transurban City Link Ltd* (1996) 20 ACSR 388 discussed at footnotes 125 and 126 of Chapter 6. For an extreme fact situation involving disclosure issues in the prospectus context see the facts of *Aequitas v AEFC* [2001] NSW 14; (2001) 19 ACLC 1,006 (SCNSW, Austin J) (the case involved, among other things, alleged misstatements arising in the context of ASX compliance listings - the offerings (undertaken in the mid 1980's) had been structured to avoid the need to lodge a prospectus). See Section 5.3 analysis.

during the prospectus offering process that prospectus disclosures had been inadequate.<sup>38</sup> Following the enactment of the *CLERP Act* and the removal of ASIC's role in registering prospectuses, ASIC has stated that stop orders have become ASIC's principal means of dealing with inadequate disclosure<sup>39</sup>. In early 2001, following fallout from the "techwreck" ASIC flagged it would make further use of its stop order power to improve the quality of disclosure documents.<sup>40</sup> The issue that will be returned to is the effectiveness of this remedy.

Second, ASIC has been forceful in pursuing fundraising activities through its civil penalty powers where securities or financial products have been offered without compliance with the relevant prospectus lodgement requirements of the Corporation Act (or by persons who are not appropriately licenced under the Corporations Act). Frequently these cases are resolved through negotiated settlement with ASIC following successful interlocutory skirmishing before the Australian courts.<sup>41</sup>

Many of the cases would seem to involve very clear breaches of law that illustrate comprehensive success for ASIC and a clear regulatory success. However, because such matters are resolved without the publicity of a case before the superior courts they lack precedential value and the *in terrorem* effect that would arise from a successful prosecution or civil charges award.

**Table 2: ASIC Enforcement Record<sup>42</sup>**

Period	Refused Registration	Post Vetting	Withdrawn	Withdrawn following Post Vetting	Stop Orders Total	Interim Stop Orders	Final Stop Orders	Investigations	Other Action
1990/91	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

<sup>38</sup> *Corporations Act* 739 - where ASIC is satisfied that an offer may contravene the prohibition on prospectus misstatement, it may order that no securities issue or sale can be made while the order is in force.

<sup>39</sup> See ASIC Annual Report 2000/2001 at 35

<sup>40</sup> It was announced that 16 interim or final stop orders had been issued in the first quarter of 2001 - ASIC press release 01/112 "*Further Intervention by ASIC on Fundraising Disclosure*" (30 March 2001) (updated to more than 50 stop orders for calendar 2001 in October 2001 - J.Segal speech "*Everything the Company Director must know about Corporate Financial Disclosure and Continuous Disclosure*" (ASIC 31 October 2001)). It was further revealed that more than 40 prospectuses had been dealt with in calendar 2000 by imposing stop orders or requiring supplementary prospectuses - ASIC press release 01/052 "*Consumers Protected by Interim Stop Orders*" (22 February 2001).

<sup>41</sup> See for example *ASIC v Wiggins & Ors* (1998) 30 ACSR 190 (FCA, Finkelstein J) (investigation relating to breach of prospectus lodgement provisions).

<sup>42</sup> Sources: ASIC Annual Report 1990/1 to 2000/1.

Further in 1998/99 it was disclosed that prospectuses had been withdrawn following post vetting and stop orders had been issued in that year without providing details (Annual Report page 29) and in 1997/98 it was revealed some prospectuses had been refused registration (Annual Report page 25).

Period	Refused Registration	Post Vetting	Withdrawn	Withdrawn following Post Vetting	Stop Orders Total	Interim Stop Orders	Final Stop Orders	Investigations	Other Action
1991/92	87	319	N/A	N/A	12	N/A	N/A	N/A	63
1992/93	47	428	59	12	11	9	2	2	44
1993/94	117	302	43	6	10	8	2	7	37
1994/95	66	154	N/A	15	2	1	1	1	N/A
1995/96	54	106	N/A	7	10	6	4	N/A	N/A
1996/97	N/A	132	N/A	N/A	N/A	N/A	N/A	N/A	N/A
1997/98	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
1998/99	N/A	106	N/A	N/A	N/A	N/A	N/A	N/A	N/A
1999/2000	N/A	109	N/A	N/A	N/A	N/A	N/A	N/A	N/A
2000/2001	N/A	188	N/A	N/A	N/A	81	N/A	N/A	N/A

The question must be asked whether circumstances have arisen during the 1990s which would suggest that prospectus misstatement may have occurred in some cases. There is a basis for suspicion that tightened securities laws have not necessarily resulted in greater accuracy in prospectus documents. There have been a number of situations where issuers have entered some form of insolvency arrangement during the 1990s shortly after raising funds under a prospectus as part of an initial public offering with the result that investors have lost significant amounts.<sup>43</sup> As at 31 December 2001 no criminal or civil proceedings have arisen from any of these corporate collapses in relation to the prospectus disclosures made.

In addition, failure by issuers to meet prospectus financial forecasts have been an ongoing feature of the Australian experience. One accounting adviser has maintained a survey over much of the last 10 years of the record of issuers in meeting prospectus forecasts in initial public offerings. In the most recent survey, approximately 60% of small cap listings in 1999 were found to have underperformed their earnings forecasts by 15% or more.<sup>44</sup>

<sup>43</sup> See by way of notable examples Southern Cross Airlines Holdings Limited (prospectus dated 28 April 1992), Apollo Batteries Limited (prospectus dated 16 June 1993) in the 1990-2000 period; Liberty One Holdings Limited (prospectus dated 11 November 1998); Eisa Limited (prospectus dated 1999), The Satellite Group Limited (prospectus dated 13 August 1999); Recruiters Australia Limited (prospectus dated October 1999); Australian Plantation Timber Limited (prospectus dated April 2000)).

<sup>44</sup> PricewaterhouseCoopers "Survey of Sharemarket Floats 2000" (PricewaterhouseCoopers © 2001) at page 14. This is much larger than for large cap listings (market value of greater than A\$100 million) and higher than in prior years (average of 40% underperforming for small caps), likely reflecting the effects of the tech wreck of 2000.

While, for the reasons discussed in Section 6.3, a failure to achieve a prospectus forecast does not necessarily equate to a prospectus misstatement, the intuitive response of any professional involved in the Australian capital markets is that there must have been many prospectus misstatements during the 1990s that have not been pursued through criminal or civil actions.

In April 2001, the new ASIC chairman announced an intention to pursue prosecutions arising from unacceptable levels of companies failing to achieve prospectus forecasts.<sup>45</sup> However, it will be interesting to observe whether these assertions lead to a higher enforcement level.

The initial conclusions that can be drawn from the above survey are as follows:

- There has been no significant record of enforcement of Australian law, either civilly or criminally, for prospectus misstatement.
- The case law that does exist identifies a poor record of successful enforcement action.
- To date, the enactment of the *Corporations Law* has not resulted in a change in historical enforcement patterns.

Despite these observations, in the specific area of prospectus misstatement liability one feature of the enforcement of Australia's securities laws has been an expanding incidence of large scale civil actions, typically brought in the name of companies that have suffered a corporate collapse, to seek recover against directors and advisors, typically who are "deep pocket" defendants through the availability of insurance arrangements.<sup>46</sup>

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<sup>45</sup> "Further Intervention by ASIC on Fundraising Disclosure" ASIC Press Release 01/112 dated 30 March 2001.

On 16 January 2002 the first prosecutions for offering securities under a disclosure document which contained a misleading or deceptive statement were laid - "ASIC Charges Melbourne Dotcom Directors" ASIC Press Release 02/15.

Perhaps these developments will mark the start of a new mood of enforcement in relation to the prospectus misstatement sanctions. At the time of writing it is too soon to know.

<sup>46</sup> See for example major civil litigation in the 1990s such as *Duke Group Ltd (in liq) v Pilmer & Ors* (1999) SASC 97; 31 ACSR 213 (SCSA, Doyle CJ, Duggen & Bleby JJ) (liquidator action against accounting advisors in merger); *Equiticorp Finance Ltd (in liq) v Bank of New Zealand & Ors* (1993) 11 ACSR 642 (SCNSW CA, Kirby P, Clarke & Cripps JJA) (liquidator action against financier); *Spedley Securities Ltd (in liq) v Greater Pacific Investments Pty Ltd (in liq) & Ors* (1992) 7 ACSR 155 (SCNSW, Cole J) (liquidator action to set aside transactions). A number of other similar cases settled before judgment being handed down by the court.

These cases have generally involved claims based on the general causes of action discussed in Chapter 5. The cases have not generally involved circumstances where an initial public offering has been undertaken.<sup>47</sup>

However, it is obvious that the success rate of such cases in the 1990's is encouraging a culture of litigation.

Further, the class action provisions of Australian law<sup>48</sup> are increasingly being utilised to enforce causes of action available for securities law violations. The most well known of these cases in the late 1990's is the GIO class action<sup>49</sup> that is not due to go to trial until the mid 2000's.

What the above considerations suggest is that the civil litigation environment may be changing. The above analysis of prospectus disclosure experience confirms that many investors have lost significant sums in circumstances that may suggest dubious disclosure practices. As attitudes to civil litigation change it cannot be assumed that the historical inactivity in this area will remain, even absent changed litigation.

#### 1.4 A SHORT HISTORY OF PROSPECTUS REGULATION IN KEY JURISDICTIONS

The *Corporations Act* requirements relating to prospectus disclosure should initially be approached by appreciating the historical context of the legislation. A historical review demonstrates that:

- There is nothing new about the debate concerning prospectus regulation that arose in the 1980s and 1990s in Australia. That debate and a perceived concern as to abuses in relation to capital raising has been a consistent theme in many jurisdictions over the last 200 years following cycles of boom and bust in the securities markets.
- Legislation seeking to permit regulatory bodies to determine the appropriateness of securities offerings for investors (so called "merit legislation") has never successfully been implemented in any jurisdiction.<sup>50</sup>

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<sup>47</sup> The possible exception is the action bought by NRMA against its legal advisors for the failed demutualisation of that entity - *NRMA Ltd & Ors v Morgan & Ors* (1999) 31 ACSR 435 (SCNSW, Giles J); *Heydon & Ors v NRMA & Ors* [2000] NSWCA 374; 36 ACSR 462 (Malcolm AJA, McPherson AJA, Ormiston AJA).

<sup>48</sup> See discussion in Section 3.3 below.

<sup>49</sup> This litigation relates to a class action bought in the name of shareholders of GIO Holdings Limited against the directors of that company for recommendations made in relation to the takeover bid made by AMP Limited in 1998.

- A system of mandatory disclosure backed by appropriate systems of sanctions for misstatement is the orthodox legislative response to the regulation of fundraising.
- There is a remarkable correlation between the structure of the prospectus liability rules in key jurisdictions around the world (developed from an English genesis). What does differ is the history of enforcement of those rules. The prospectus laws are vigorously enforced in the United States with a much lower incidence of enforcement elsewhere.

An appreciation of the historical background in key jurisdictions therefore provides a basic reference point for analysis of the current *Corporations Act* provisions.

### **The English Experience<sup>51</sup>**

Specific regulation addressed at capital raising had its genesis in England in the early 18th century. As England was the dominant economic force of the Eighteenth and Nineteenth centuries, it is not surprising that it was in England that the modern prospectus liability rules developed.

The English corporations and securities laws were developed through recommendations of a number of law reform committees reporting over the last 200 years. Reference to the work of those committees records the development of the fundraising provisions of the modern securities laws. While the regulation of fundraising was only one part of the development of the laws over this period it has always been a pivotal part and one of the first sections of the legislation to be developed in its modern form. This reflects the significance of the capital raising process to the operation of the securities markets. It also reflects the commercial incentives on those involved in the capital raising process to be “economical with the truth”, particularly when market conditions turn difficult.

Prior to the 18th century the offering of securities to the public was largely unregulated in England.<sup>52</sup> An unregulated securities market fuelled by colonial expansion led to the “bubble

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<sup>50</sup> See the analysis of merit legislation in Section 1.6 at text accompanying footnote 214.

<sup>51</sup> For a useful summary of relevant material see *Knauss (1964)*; *Little (1991)*; *Gower (1992)* at 19-54; G. Walker “*Reinterpreting New Zealand Securities Regulations*”, Chapter 4 of Walker, Fisse & Ramsay “*Securities Regulation in Australia and New Zealand*” 2nd Edition, 1998, Oxford University Press.

<sup>52</sup> Broker/dealer licensing was the only securities law regulatory focus prior to this time - see for example “An act to restrain the number and ill practice of brokers and stock jobbers” of 1697 (8 & 9 Wm 3) which had its antecedents in the thirteenth century. For a general discussion see *Gower (1992)* at 24.

mania” of the early 18th century<sup>53</sup> that had its high water mark in the memorable prospectus that offered shares in a company “for carrying on an undertaking of great importance, but nobody to know what it is”.<sup>54</sup>

During this period the “Bubble Act” of 1719 was passed by the English Parliament prohibiting the raising of capital through the corporate entity, except for companies created by royal charter.<sup>55</sup> This legislative solution was unworkable as it essentially prohibited the public offering of stock in joint stock companies. The prohibition of stock offerings was closely followed by a market downturn and the ultimate demise of The South Sea Company.<sup>56</sup>

Over the following century the use of the company vehicle to raise capital in England was very difficult because of the requirement of incorporation through act of royal charter, rather than limited liability being available to business enterprises through general facilitating legislation.<sup>57</sup>

Ultimately the unworkability of the merit legislation reflected by the Bubble Act was recognised by its repeal in 1825 and the adoption of the first modern companies legislation, the *Companies Act 1825*.<sup>58</sup>

The initial companies legislation did not address the regulation of capital raising. In 1841, a parliamentary committee was appointed to study the regulation of the securities markets, including issues relating to prospectus misstatement. That committee, known as the Gladstone committee<sup>59</sup> led to recommendations designed to address the “evil of fraudulent and fictitious companies” offering securities to the public.<sup>60</sup> This was achieved through the

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<sup>53</sup> See Melville “*The South Sea Bubble*” 1921; Erleigh “*The South Sea Bubble*” 1933; Baron “*Bringing Back the Bubble? Regulation of Corporate Abuse by an Action in Public Nuisance*” (1992) 11 *Uni of Tas L Rev* 149.

<sup>54</sup> See Melville *Ibid* at 97.

<sup>55</sup> 6 Geo 1, c.18. The Bubble Act authorised a proposal by The South Sea Company (a company created by royal charter in 1694) to acquire the national debt of England in exchange for shares in the company as well as prohibiting the public from investing in companies that were not created by royal charter.

<sup>56</sup> The securities of The South Sea Company were bid up almost 800% in the first 7 months of 1720 only to fall by a greater amount before the end of that year (a parallel no doubt that is a parable of the turn of this century’s technology boom).

<sup>57</sup> See Walker *supra* note 51 at 92-3.

<sup>58</sup> 6 Geo. 4, c.91. The 1820s were a period of speculative boom. The reason given for the repeal of the Bubble Act was that it restricted the formation of companies “established on just and equitable and for laudable objects” - Walker *supra* at 93 citing Hunt “*The Development of the Business Corporation in England 1800-1867*” 1936 at 41.

<sup>59</sup> “*First Report of Select Committee on Joint Stock Companies*” (1844, House of Commons).

<sup>60</sup> The Gladstone committee report classified bubble companies into 3 classes - those faulty in nature, those ill-constituted and those fraudulent in object.

*Companies Act 1844*<sup>61</sup> which for the first time required the registration of prospectuses as a precondition to securities offerings. This legislation is the direct predecessor of the structure of modern prospectus regulation.

The legislation required offering documents to be registered as a prospectus but did not specify the contents of a prospectus. Significantly, the legislation did not seek to regulate the types of investment that could be offered. As Gladstone famously said in introducing the legislation:

“Publicity is all that is necessary. Show up the roguery and it is harmless.”<sup>62</sup>

The companies legislation was next reviewed by a Royal Commission of 1854, but no changes to the prospectus provisions were recommended.<sup>63</sup> However, perplexingly, the resultant *Joint Stock Companies Act 1856* that consolidated the previous legislation deleted the prospectus registration requirements of the 1844 *Companies Act* and therefore represented a step back for the regulation of fundraising.<sup>64</sup>

Up until this point, no provision in the companies legislation had imposed liability on a person involved in the prospectus preparation process for a misstatement. This was dealt with by the common law remedies of rescission and the tort of deceit, both remedies being the subject of continued development of relevant legal principles by the courts at that time.<sup>65</sup>

In 1861 statutory criminal liability was imposed for prospectus misstatement by the enactment of the *Larceny Act 1861*<sup>66</sup>. This was the first statute to impose a liability regime on persons involved in the capital raising process and is the antecedent of the criminal offence contained in section 729(3) of the *Corporations Act*. Section 84 of the *Larceny Act* provided that it was a

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<sup>61</sup> *Joint Stock Companies Act 1844* (7 & 8 Vict. c.110); *Companies Clauses Consolidation Act 1845*, (8 & 9 Vict. c.16). In addition this legislation introduced amendments to require the keeping of accounting records, the presentation of annual financial statements at shareholders meetings and a requirement for the preparation of audited financial statements.

<sup>62</sup> Speech in the House of Commons (Hansard LXXXV (1844) at 277). The Gladstone committee report had recommended that disclosure was the appropriate regulatory response in relation to each of the 3 classes of bubble company noted above. Its recommendations were that, in relation to companies that were faulty in nature, disclosure would allow the investor to assess that fact, in relation to companies that were ill constituted, periodic disclosure and strengthening directors duties would be the appropriate response and, in relation to fraudulent companies, disclosure of directors and promoters would allow the public to avoid those persons in the future.

<sup>63</sup> The recommendation of the Royal Commission was to delete the mandatory reporting and audit requirements of the legislation in favour of non-mandatory model articles of association.

<sup>64</sup> The *Joint Stock Companies Act 1856* (19 & 20 Vict. c.47) also omitted compulsory annual reporting and audit requirements (a model form of articles was instead inserted that provided for these matters, although it was possible to opt out of the model provisions).

<sup>65</sup> See the discussion in Section 5.3.

<sup>66</sup> (24 & 25 Vict. c.96)

misdeemeanour for a director, manager or public officer to circulate or publish a statement that “he shall know to be false in any material particular” with intent to deceive.

The liability position was further changed with the *1867 Material Contracts Act*, an amendment to the then *Companies Act*. This legislation imposed the first content requirements for a prospectus. The *1867 Material Contracts Act* provided that the tort of deceit was deemed to have occurred if the date and the names of the parties to any contract entered into by the company and its promoters were not disclosed in a prospectus.<sup>67</sup> However, the legislation did not require disclosure of the terms of the contract and the term “prospectus” was not defined.<sup>68</sup> This legislation was the predecessor of the requirement to disclose material contracts in a prospectus, a requirement finally abolished as a formal matter in Australia by the *CLERP Act*.

The next development from the prospectus perspective was the civil remedy in the *1890 Directors Liability Act*. The *1890 Directors Liability Act* was an immediate legislative reaction to the House of Lords decision in *Derry v Peek* (discussed in Section 5.3 below) and its imposition of a fraud standard of culpability for prospectus misstatement at common law under the tort of deceit.<sup>69</sup> The intention of the legislation was to shift the onus of proof in bringing a claim of prospectus misstatement so that a plaintiff need only prove prospectus misstatement, with the director or promoter required to then establish reasonable grounds of belief to escape civil liability.

The legislation made a director, “promoter” or any person who “authorised” the issue of a prospectus liable for an “untrue” statement in a prospectus unless they could establish certain defences.<sup>70</sup> In relation to statements not made on the authority of an expert, it was necessary to show reasonable grounds of belief and actual belief in the truth of the statement.<sup>71</sup> In relation to statements made by an official or expert, it was necessary to establish the statement fairly represented the statement of that person and a reasonable belief in the competence of that person.<sup>72</sup> This standard of culpability has remained largely unchanged since the enactment of that

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<sup>67</sup> The section stated the prospectus:

“shall be deemed fraudulent on the Part of the Promoters, Directors, and Officers of the Company knowingly issuing the same.”

<sup>68</sup> See the discussion in *Barnett (1934)* at 5-6.

<sup>69</sup> For a contemporary description see the comments of Cozens-Hardy LJ in *McConnel v Wright* [1903] 1 Ch 546 at 558. See also *Walker* supra note 51 at 105-6.

<sup>70</sup> Section 3(1) of the *1890 Directors Liability Act*.

<sup>71</sup> Section 3(1)(a) of the *1890 Directors Liability Act*.

<sup>72</sup> Section 3(1)(b) and (c) of *1890 Directors Liability Act*.

legislation. The *1890 Directors Liability Act* is therefore the direct antecedent of the structure of the modern prospectus liability regime reflected in section 728 and section 729 of the *Corporations Act*.

Following the adoption of the *1890 Director Liability Act* (and coinciding with the depression of the 1890s) the Davey committee was commissioned to report on the corporations and securities laws.<sup>73</sup> The Davey committee in reviewing the appropriateness of prospectus regulation, observed that legislation cannot protect people from the consequences of their own imprudence but, on the other hand, a person who is invited to subscribe for securities on the basis of a prospectus has no opportunity of making independent investigation of the issuer and therefore is deserving of protection.<sup>74</sup> The 1890s report of the Davey committee was followed shortly after by the report of the Loreburn committee in 1906.<sup>75</sup> Neither the Davey committee or the Loreburn committee recommended any significant changes to the prospectus regime, although the companies legislation was consolidated in 1908 with the incorporation into the general companies legislation of the provisions of the *1890 Directors Liability Act*.<sup>76</sup>

Boom and bust in the securities markets were again a feature of the 1920s, resulting in the appointment of the Greene committee and its report of 1926.<sup>77</sup> In reviewing the prospectus provisions of the *Companies Act 1908*, the Greene committee considered that the then existing law in England regarding prospectuses was on the whole satisfactory.<sup>78</sup> A number of changes were proposed. The major initiatives were the introduction of the predecessor to the anti-

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<sup>73</sup> “*Report of the Departmental Committee Appointed by the Board of Trade to Inquire What Amendments Are Necessary In the Acts Relating to Joint Stock Companies Incorporated with Limited Liability Under the Companies Acts 1862 to 1890*” (1895, HM Stationary Office). The primary impetus for the constitution of the Davey Committee was the 1893 stock market collapse which primarily affected mining companies operating in Africa.

<sup>74</sup> Davey committee report at paragraphs 4-7.

<sup>75</sup> “*Report of the Company Law Amendment Committee*” (1906, Cmnd 3052). The outcome was the *Companies Act 1907* (7 Edw 7, c.50) and the *Companies (Consolidation) Act 1908* (8 Edw 7, c.69). The companies legislation in England was amended and consolidated into a single statute. The civil liability regime for prospectus misstatement was contained in section 84 of the legislation. The section reflected the *1890 Directors Liability Act* with some minor formatting changes.

It was in this legislation that the *1867 Material Contracts Act* was transformed into a disclosure obligation to disclose the date and parties of material contracts (section 81(k)).

<sup>76</sup> The emphasis of the debate by the Loreburn committee was on the mandatory requirement to prepare financial statements and have those statements audited, following the removal of that requirement as a result of the Royal Commission of 1854 - for discussion see *Little (1991)* at 90.

<sup>77</sup> “*Report of Company Law Amendment Committee 1925-6*” (1926, Cmnd 2657). The Greene committee was commissioned to report generally on desirable reforms to the English companies legislation (at paragraph 2).

<sup>78</sup> See paragraph 38 of the Greene committee report. The Greene committee reflected a strong market efficiency approach to regulation. It was said that the risk of fraud and other malpractices from time to time should not be dealt with by legislation that imposes intolerable fetters on honest business (at paragraphs 8-9).

avoidance provisions of CA section 707(3) and the share hawking provisions.<sup>79</sup> The Greene committee report resulted in the adoption of the *Companies Act 1929*.<sup>80</sup>

Despite the great depression, companies and securities laws were not reviewed in England again until the work of the Cohen committee reporting in 1945.<sup>81</sup> The Cohen committee report contained a much more extensive scrutiny of the prospectus liability provisions of the companies legislation than that undertaken by any prior review committee. It was considered that the losses suffered by investors in the great depression caused a feeling that the law relating to prospectuses was inadequate.<sup>82</sup>

The Cohen committee report was the genesis of a number of important changes to the prospectus liability rules of the corporations and securities legislation and contains the basis of the most significant changes that were made to the structure of the liability provisions of the legislation since the enactment of the *Larceny Act 1861* and the *1890 Directors Liability Act*.

The most significant recommendations were to impose potential civil liability on experts' for statements made by those persons in a prospectus<sup>83</sup> and to incorporate a criminal offence for prospectus misstatement in the corporations and securities legislation, as distinct from the crimes legislation.<sup>84</sup>

The Cohen committee report also contained a recommendation that the statutory formulation of liability extend not only to false statements but also to misleading statements<sup>85</sup> as well as to

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<sup>79</sup> Less significant recommendations made were in relation to the disclosure of past dividend history and profit history of issuers and businesses acquired, a tightening of the minimum subscription requirements of the legislation and a restriction on the payment of excessive underwriting commissions (the concern was that such payments could be used to effectively permit the issue of shares at a discount).

The liability provisions of the legislation were not commented upon at all.

In addition to prospectus issues, proper record keeping, annual reporting requirements and audit requirements were the focus of a number of detailed recommendations made to improve the operation of the securities laws.

<sup>80</sup> *Companies Act 1929* (19 & 20 Geo 5, c 23). The civil liability regime was contained in section 34 of the legislation. It became the genesis of Australian companies legislation enacted after that time. The section was little changed from the *Companies Act 1908*.

It was also the source of the US securities law provisions (see discussion below).

<sup>81</sup> Board of Trade "*Report of the Committee on Company Law Amendment*" (1945, Cmnd 6659). Again, the Cohen committee was commissioned to report on what major amendments were desirable to the then companies legislation.

<sup>82</sup> See paragraph 7(a) of the Cohen committee report. It was noted however that the *Companies Act 1929* (England) and revised rules of the London Stock Exchange were not in effect at the time the crash had occurred (at paragraph 7(a)).

<sup>83</sup> See paragraph 44 of the Cohen committee report.

<sup>84</sup> See paragraph 42 of the Cohen committee report.

<sup>85</sup> See paragraph 42 of the Cohen committee report. The distinction between a false statement and a misleading statement was not explained.

omissions which would have the effect of rendering prospectus statements misleading.<sup>86</sup> The recommendations resulted in the adoption of the *Companies Act 1948*.<sup>87</sup>

The next English committee of inquiry was the Jenkins committee reporting in 1962.<sup>88</sup> The Jenkins committee report did not contain any significant recommendations in relation to the prospectus liability provisions of the corporations and securities laws.<sup>89</sup>

It is interesting to note that the Jenkins committee received detailed submissions on the United States model of securities regulation.<sup>90</sup> After reviewing the structure of the United States securities laws and the role performed by the SEC, the Jenkins committee concluded that no fundamental changes to the then structure of the English regulatory bodies was warranted.<sup>91</sup>

The most recent committee review of the operation of the English securities laws was undertaken by Professor Gower reporting in 1984 and leading to the enactment of the *Financial Services Act 1986*.<sup>92</sup> The main initiatives of the Gower report were to integrate the disparate sources of the English securities laws that had arisen from various legislative sources over the prior 80 years<sup>93</sup> and to establish new regulatory bodies (self regulation within a statutory framework). One area of comment by the Gower report was to remark on criticisms that the English securities laws were not adequately enforced.<sup>94</sup> It was proposed that those concerns be dealt with through the

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<sup>86</sup> See paragraph 36 of the Cohen committee report.

The Cohen committee report also contained certain less significant proposals that are indirectly relevant to this dissertation including:

- The requirement of the written consent of an expert to the inclusion of their report in a prospectus (paragraph 36).
- The availability of material contracts for inspection but no requirement that the prospectus summarise the contracts in detail. (See paragraph 31 of the Cohen committee report - it was suggested details of material contracts “would swell the prospectus to inordinate length without necessarily conveying clear information to the ordinary investor”).

<sup>87</sup> The civil liability regime was contained in section 43 of the legislation. The new criminal liability regime was contained in section 44 of the legislation.

<sup>88</sup> Board of Trade “*Report of the Company Law Committee*” (1962, Cmnd 1749).

<sup>89</sup> Some consideration was given to the predecessor provisions of section 1041E and section 1041F of the *Corporations Act* (Section 13 of the *Prevention of Fraud (Investments) Act 1958* (England)). After considering the desirable policy basis of such provisions it was recommended that criminal liability should only arise in circumstances where dishonesty is involved while civil liability should apply where a negligence standard of conduct is established. For discussion of these provisions see section 5.2.

<sup>90</sup> See paragraph 3 of the Jenkins Committee report. Witnesses included Professor L. Loss from the United States.

<sup>91</sup> See paragraph 228 of the Jenkins Committee report.

<sup>92</sup> “*Review of Investor Protection*” (1984, Cmnd 9125).

<sup>93</sup> See Gower report at 9.12 - 9.15 in relation to the regulation of prospectuses.

<sup>94</sup> See Gower report at 10.12.

creation of new regulatory bodies, through the creation of broader sanctions and through greater collaboration between agencies.<sup>95</sup>

Over the last 20 years the story of English securities regulation has reflected a move to adopt European Union models so as to achieve the integration of the regulatory regimes for securities offerings within the EU. This is illustrated by the adoption of the *Financial Services Act 1986* as it applies to prospectus content<sup>96</sup>, now replaced by the *Financial Services and Markets Act 2000*<sup>97</sup>. However, as discussed below, while prospectus content is a matter subject to EU directive, prospectus liability is not so regulated and the English liability rules continue to reflect their historical genesis.

Clearly the English model of prospectus regulation was established by a tortuous path of review and reporting, linked to boom and bust in the securities markets over the last 200 years. One outside observer summed up the position in the 1960s as follows:

“The history of English securities regulation may be summarised as repeated attempts to increase the effectiveness of the required disclosure. Content of the prospectus was specified in detail; requirements for distributing and filing a prospectus were increased; civil liability of parties preparing a prospectus was tightened; and a distinction was made between private and public companies, with disclosure requirements applying only to the latter.

Only in the past 30 years has there been reasonably effective protection of investors in England concerning new issue distribution.”<sup>98</sup>

At the turn of the century there was a vibrant record of cases in England concerning prospectus misstatement and, unlike the Australian experience, liability was established in a number of those cases against directors and promoters, both under the tort of deceit and under the liability

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<sup>95</sup> Gower report at 10.12 - 10.32.

Unfortunately the resulting framework was cumbersome and likely to have undermined the effectiveness of the regulatory regime in the United Kingdom - see *Gleeson & Bloomenthal (1999)* at 360 - 1. From 1 December 2000, a “super regulator” body, the Financial Services Authority was created through the merger of certain of the self regulatory authorities pursuant to the *Financial Services and Markets Act 2000*.

<sup>96</sup> The provisions were contained in Part IV of the *Financial Services Act 1986* (for listed securities) and Part II of the *Public Offers of Securities Regulations 1995* (for unlisted securities). For discussion see A. Alcock “*Public Offers in the UK: The New Regime*” (1996) 17 *Comp Law* 262; *Gleeson & Bloomenthal (1999)*.

<sup>97</sup> The *Financial Services and Markets Act 2000* involved the creation of the new Financial Services Authority with effect from 1 December 2001. The legislation did not introduce any material change to prospectus regulation from the *Financial Services Act 1986*. The regulation of unlisted securities remains subject to *The Public Offers of Securities Regulation 1995*.

<sup>98</sup> *Knauss (1964)* at 612.

provisions of the companies legislation.<sup>99</sup> While the English experience in relation to the enforcement of prospectus misstatement was initially more extensive than reported in Australia, in England too, there has not been any significant case law record in recent decades.

### The United States experience

The development of securities laws occurred much later in the United States than it did in England (or Australia for that matter). That is not surprising having regard to the tradition of unrestrained capitalism that characterised late 19th century American society.

By the early decades of the 20th century there was strong populist support for some legislative control of the abuses that were perceived to be a feature of a completely unregulated stock market environment. The most famous statement of support for the introduction of a disclosure based regulatory regime to control aspects of the securities markets comes from Brandeis in 1914:

“Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”<sup>100</sup>

In other words Brandeis was advocating the appropriateness of a disclosure based regulatory regime for the securities markets. The similarity between the sentiments expressed in this statement and the comments made by Gladstone in England more than 50 years earlier are obvious.

Berle & Means in their landmark treatise on corporations had also recognised the critical role to be performed by disclosure in regulating corporations where management is divorced from ownership. This conclusion is based on a recognition that an investor must buy and sell securities on the faith of a market appraisal of the value of the securities and the market cannot operate properly unless there is free and equal information available to investors concerning all companies.<sup>101</sup>

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<sup>99</sup> See for example the successful actions in notable reported cases such as *Adams v Thrift* [1915] 1 Ch 557, 2 Ch 21; *JP Coats v Crossland* (1904) 20 TLR 800; *Greenwood v Leather Shod Wheel Company* [1900] 1 Ch 421; *Dringbier v Wood* [1899] 1 Ch 393; *Aaron's Reefs v Twiss* [1886] AC 273; *Sullivan v Mitalfe* (1880) 5 CPD 455.

<sup>100</sup> L. Brandeis “*Other People's Money and How the Bankers Use It*” 1914 at 92. This statement was made in relation to the non-disclosure by J.P. Morgan & Co of the amount of underwriting commission it received on the sale of securities.

<sup>101</sup> A. Berle & G. Means “*The Modern Corporation and Private Property*” 1933 at 300-325.

However, even earlier, various State legislatures had attempted to address the issue of perceived securities fraud through the introduction of forms of merit legislation. The first state to do so was Kansas in 1911 and thus the “blue sky” laws of the United States developed.<sup>102</sup>

The stock market collapse of 1929 had a profound impact on the United States securities markets. Following the great crash, the United States Senate conducted hearings from 1932 to 1934 which provided damning evidence of fraudulent activities undertaken by promoters and underwriters in relation to prospectuses that had been issued during the 1920s, including deliberate misstatements in offering documents and high pressure selling tactics. The mood of the time is well expressed by the following house report:

“During the post-[World War I] decade some 50 billions of new securities were floated in the United States. Fully half or \$25,000,000,000 worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities. The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest and prudent dealing that should be basic to the encouragement of investment in any enterprise. Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor’s attention those facts essential to estimating the worth of any security. High-pressure salesmanship rather than careful counsel was the rule in this most dangerous of enterprises.”<sup>103</sup>

In addition to specific disclosure issues, a plethora of fraudulent practices were probably of greater concern. Market manipulation through fictitious trading activities was rife. In addition, excessive promotional profits, conflicts of interest and self dealing were identified as particular problems.<sup>104</sup>

Proposals for the reform of the United States capital markets became part of the political platform of the Democrat Party in the 1932 presidential campaign that saw Franklin D Roosevelt elected as President.<sup>105</sup> During the 1920s the merit legislation of the state based blue sky laws had

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<sup>102</sup> See for example *Loss (1992)* at 8 and *Goodkind (1976)* at 81-106. The term “blue sky” laws was used to describe legislation directed at promoters who “would sell building lots in the blue sky in fee simple” (*Loss (1992)* at 8; *Goodkind (1976)* at footnote 1).

Blue sky laws imposed restrictions on the types of offerings that may be made by companies - for example a certain level of financial performance would be required.

While blue sky laws remain in place in most United States jurisdictions their continued relevance is open to question. In 1996 the *National Securities Markets Improvement Act* amended section 18 of the *Securities Act 1933* to pre-empt state securities laws to the extent that they impose merit review on certain offerings.

<sup>103</sup> HR Report No 85, 73d Congress, 1st Sess 2 (1933) reproduced in *Scott (1986)* at 235.

<sup>104</sup> Senate Committee on Banking and Currency, 72d & 73d Congress 1st and 2nd sessions (1932-4) described in *Anderson (1974)* at 316-8. See also the description in James “*The Securities Act of 1933*” (1934) 32 Mich L Rev 624.

<sup>105</sup> See *Knauss (1964)* at 613 and *Anderson (1974)* at 318 and materials referred to there.

applied to regulate securities offerings but it was perceived that the states did not have adequate resources to apply and enforce the laws properly. In addition the leading securities houses had obtained exemption from the statutes in the 1920s by arguing self regulation would be more effective. Clearly self regulation did not work in the 1920s.<sup>106</sup>

The *Securities Act* of 1933, known as the “Truth In Securities” Bill, was premised on full disclosure to investors in the capital raising process.<sup>107</sup> The Bill was introduced into the Congress by Roosevelt in the following terms:

“This proposal adds to the ancient rule of caveat emptor, the further doctrine “let the seller also be aware”, and puts the burden of telling the whole truth on the seller.”<sup>108</sup>

What is less well known is that the original drafts of the *Securities Act* had contemplated the federal introduction of merit legislation so that permission to sell securities could be denied on an administrative finding that the business of the issuer was not based on “sound principles”, that the issuer was “dishonest” or that the issuer was in “unsound condition or insolvent”.<sup>109</sup> That philosophic approach to regulation, while consistent with the state blue sky laws, was ultimately rejected on the basis that such an approach to regulation would prove to be administratively impractical. President Roosevelt made the following comments to Congress in relation to this aspect of the then proposed *Securities Act*:

“Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.”<sup>110</sup>

The overriding policy objective of the new legislation was to protect unsophisticated investors from the abuses seen in the 1920s. The drafting of the legislation was based on the *Companies Act 1929* of England<sup>111</sup> and contained four key elements - the filing of a registration statement for offerings, the imposition of a waiting period before sales could be made, the delivery of a

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<sup>106</sup> See *Anderson (1974)* at 318 referring to M. Parrish “*Securities Regulation and the New Deal*” 1970 at 23-40.

<sup>107</sup> The preamble to the *Securities Act* describes it as “An act to provide full and fair disclosure of the character of securities .... and to prevent frauds in the sale thereof”.

<sup>108</sup> H.R. Rep No 85, 73d Congress, 1st Session 2 (1933). This philosophy has since been described by the United States Supreme Court as the “fundamental purpose” of the securities laws - *Affiliated Ute Citizens of Utah v United States* 406 US 128 (1972) at 151.

<sup>109</sup> See the description in *Landis (1959)* at 30-2 and *Knauss (1964)* at 615.

<sup>110</sup> H.R. Report No 85, 73d Congress, 1st Sess 2 (1933) cited in *Landis (1959)* at 30. See also *Greene (1981)* at 767-7; *Curnin & Ford (2001)* at 197 - 8.

<sup>111</sup> See the description in *Landis (1959)* at 34 (J Landis was one of the draftsmen of the 1933 Act) and *Knauss (1964)* at 615.

prospectus before sales could be concluded and civil liability provisions for misstatements.<sup>112</sup>

The cornerstone of the liability regime for prospectus misstatement is section 11 of the *Securities Act*, applicable to any misstatement in a registration statement, and section 12(2) of the *Securities Act*, applicable to misstatement made in selling securities generally. Section 11 is based directly on the *1890 Directors Liability Act*<sup>113</sup> and was intended to impose honesty, care and competence on those facing potential liability.<sup>114</sup>

The liability regime in the initial 1933 legislation was much more rigorous than the current formulation of that legislation. First drafts of the legislation contained no defences for the persons facing primary civil liability listed in section 11. However Congress introduced various modifications, including the due diligence defences for all parties except the issuer, as it was perceived to be unfair to hold such persons responsible for innocent mistakes in the prospectus offering process.<sup>115</sup>

Even with these modifications the bill as introduced led to great concern in the financial community. The outcome was amendments to the legislation in 1934 at the time of the introduction of the *Securities Exchange Act* 1934 to soften the effect of the legislation.<sup>116</sup> In the intervening period there had been what is commonly referred to as a “capital strike”.<sup>117</sup>

In the period from the 1930s to the 1960s in the United States the applicable legislative regime was relatively static, although by the mid 1960s there were a number of critics of the disclosure process as it then operated.<sup>118</sup>

The most marked observation of the United States experience is a 35 year hiatus before section 11 of the *Securities Act* 1933 gave rise to any significant litigation. Prior to the 1960s, despite a

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<sup>112</sup> See *Anderson (1974)* at 324-26.

<sup>113</sup> As noted in *Landis (1959)* at 35, section 11 is drawn generally from the English *Companies Act* but carefully revised to meet the objectives of the United States legislation.

<sup>114</sup> See *Anderson (1974)* at 326.

<sup>115</sup> See *Douglas & Bates (1933)* at 172-3; *Note (1981)* at 379-385.

<sup>116</sup> The first change made in the amending legislation was to change the standard of inquiry required to establish the due diligence defence from that of “a person occupying a fiduciary relationship” to that of a “prudent man in the management of his own property”. The second significant change was to introduce a requirement for reliance to establish a right to damages where there has been a subsequent earning statement released. Thirdly, the damages formulation was modified by placing a specific cap on the liability of underwriters but not other persons with primary liability. Fourthly, the statute of limitations was reduced from ten years to three years.

<sup>117</sup> The mood of the time is reflected in *Douglas & Bates (1933)* at 173 and 214 and *Shulman (1933)* at 247-8. It has been suggested that the main cause of the capital strike in that year had to do with deliberate misinterpretation of the effect of the *Securities Act* by persons prominent in the financial world and their lawyers - see *Landis (1959)* at footnote 18.

<sup>118</sup> See discussion in section 1.6 below. The seminal criticism was that contained in *Cohen (1966)*.

number of economic cycles, only a minuscule number of actions had been commenced under section 11.<sup>119</sup> Of that minuscule number of actions there had only been two reported cases referring to section 11<sup>120</sup> and only a handful of Securities Exchange Commission proceedings dealing with section 11.<sup>121</sup> None of that material involved any comprehensive analysis of section 11 liability.<sup>122</sup>

That inactivity changed quite dramatically in the eyes of the investment community with the “Wall Street bombshell”<sup>123</sup> of the 1968 district court decision in the *BarChris Case*. In addition to being the first real use of the section after 35 years of inactivity, the *BarChris Case* became the seminal section 11 case because of the number and types of defendants found liable.

The *BarChris Case* resulted in a psychological jolt to securities professionals in the United States<sup>124</sup> that marked the start of a new period of focus on section 11 and a series of section 11 cases in the following decade providing significant guidance on the scope of prospectus misstatement liability.<sup>125</sup>

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<sup>119</sup> *Loss (1961)* had tabulated only 13 section 11 actions since 1933, cited in *Folk 1 (1969)* at 6. See also L.Loss “*The Opinion*” (1969) *Bus Law* 527 at 531.

<sup>120</sup> *Martin v Hall* 92 F 2d 208 (1937, DC Cir) cert den 302 US 726 (jury instruction relating to standard of inquiry) and *Shonts v Hirliman* 28 F Supp 478 (1939 S D Cir) (accountants liability under section 11 for contingent liability).

<sup>121</sup> See *Charles E Bailey & Company* 35 SEC 33 (1953) (underwriters liability); *In the Matter of Richmond Corp* 41 SEC 398 (1963) (underwriters liability).

<sup>122</sup> Despite the absence of a litigation history at least one observer in this period commented that the liability provisions had resulted in “an extraordinary high sense of care and responsibility in the preparation of registration statements” - *Cohen (1966)* at 1355.

<sup>123</sup> (1968) 160 NYLJ at 1 and see *Folk 1 (1969)* at 4.

<sup>124</sup> The *BarChris Case* gave rise to a huge amount of academic material on section 11, much of it now fairly dated for the purposes of this dissertation. One article written at the time, *Folk 1 (1969)* and *Folk 2 (1969)* has become the definitive exposition of section 11. Other articles such as *Harbers (1968)* and Comment “*BarChris Due Diligence Refined*” (1968) 68 *Colum L Rev* 1411 also remain influential.

The balance of the material is generally only useful to demonstrate the significant impact of the case on the sentiment in the securities markets at the time - see Note (1968) 43 *NYU L Rev* 171; Note (1968) 6 *Houston L Rev* 312; Note (1968) 43 *NYU L Rev* 103; Heller, Weiss, Israels, Schwartz “*A Dialogue on a Bad Case Making Hard Law*” (1968) 57 *Geo LJ* 221; Jordan “*BarChris and the Registration Process*” (1968) 22 *SWLJ* 790; Wyant & Smith “*BarChris: Re-evaluation of Prospectus Liability*” (1968) 3 *Ga L Rev* 122; Note “*Easing the Burden of Due Diligence under Section 11*” (1969) 17 *U Pa L Rev* 735; Evans “*The Impact of BarChris*” (1969) 21 *SC L Rev* 687. Davis & Brown “*Developments under Federal Securities Laws - BarChris and Globus*” (1969) 54 *Ia L Rev* 1038; Demmler “*New Look at Disclosure Requirements*” (1969) 40 *Pa BAQ* 547; Note (1969) *IO BC Ind & Com L Rev* 360; Symposium of Authors (Loss, Israels, Meeker, Whitney, Freeman, Henkel, Kroll) (1969) 24 *Bus Law* 523; Note (1969) 117 *U Pa L Rev* 735; (1969) 82 *Harv L Rev* 908; (1969) 16 *UCLA L Rev* 177; Note “*The Expanding Liability of Securities Underwriters: From BarChris to Globus*” (1969) *Duke LJ* 1191; Note (1969) 42 *So Cal L Rev* 293; Note (1969) 17 *Kan L Rev* 651; Note (1970) 48 *Tex L Rev* 661; (1970) *Wash L Rev* 95; (1971) *Duke LJ* 559.

<sup>125</sup> See for example the *Feit Case*; *SEC v Spectrum, LLP* 489 F 2d 535 (1973); *Competitive Associates Inc v International Health Sciences Inc* [1974-5] *Fed Sec & Rep (CCH)* 44,966; *Sanders v John Nuveen & Co* 524 F 2d 1064 (1975), 425 US 929 (1976), 554 F 2d 770 (1977), 619 F 2d 1222 (1980), 450 US 1005; *In Re Gap Stores Securities Litigation* 79 *FRD* 283 (ND Cal 1978).

It was suggested at the time a climate of laxity had developed in relation to prospectus preparation.<sup>126</sup> In part this was suggested to be a result of SEC pre-vetting of prospectuses being perceived as a form of insurance that would protect against civil liability.<sup>127</sup> In addition due diligence procedures had become ritualised as a consequence of a lack of enforcement history.<sup>128</sup> Against this background it was suggested by the more perceptive commentators that the decision was:

“precisely what one would have expected...the court’s analysis of the duty of care and the applicable standards for determining its fulfilment is virtually dictated by the statute’s language and is amply supported by legislative history”.<sup>129</sup>

In the 1980s a new period of securities litigation commenced with a rapidly accelerating frequency of securities litigation surrounding prospectuses.<sup>130</sup> To a foreign observer (or foreign issuer on the receiving end of such litigation) the United States litigation landscape was confusing and frightening. However, it would seem that the reasons for that litigation landscape had more to do with the United States court system and cultural issues than with the prospectus liability rules themselves and tended to follow an almost orchestrated process.<sup>131</sup> The key factors were class actions and the existence of the plaintiff bar as well as the way in which summary judgment and expense reimbursement for lawyers procedures worked in the United States.<sup>132</sup>

The experience was that with the rise in prominence of the plaintiff bar and class actions, in nearly all IPOs where the market price dipped below the issue price (being the trigger to a right to damages under section 11), a class action was likely to result.<sup>133</sup> While the case would typically involve allegations based on section 11, the plaintiff would generally make allegations using all

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<sup>126</sup> See *Folk I (1969)* at 4-6.

<sup>127</sup> *Folk I (1969)* at 5.

<sup>128</sup> *Folk I (1969)* at 6.

<sup>129</sup> *Folk I (1969)* at 6. An alternative view from the time as to the lack of enforcement history was that steadily rising securities markets had robbed section 11 of much of its in terrorem effect (because of the manner of quantifying damages - see Section 3.3) and lulled market participants into a false sense of security - *Harbers (1968)* at 182.

As has been noted, the original formulation of the United States securities laws provided for strict liability. The scope of that liability was cut down through the due diligence defences and through a limitation on the nature of the damages that could be recovered but with an avowed purpose of ensuring high standards in the preparation of disclosure documents through the in terrorem nature of potential liability. See *Landis (1959)* at 35.

<sup>130</sup> See *Spanner (1988)* at 116-9; *Bohn & Choi (1996)*.

<sup>131</sup> See E. Weiss & J. Beckerman “*Let the Money Do The Monitoring*” (1995) 104 *Yale LJ* 2053.

<sup>132</sup> See *Alexander (1991)* at 534-7.

<sup>133</sup> See J. C. Coffee “*Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*” (1986) 86 *Colum L Rev* 669; *Bohn & Choi (1996)*.

potential theories of liability that may apply<sup>134</sup> and claim against all persons known to have been involved in the capital raising in order to exert maximum leverage to reach a settlement.<sup>135</sup>

However, faced with litigation of this nature, summary judgment was available for defendants at little risk.<sup>136</sup> However, if the defendant loses the application for summary judgement all participants involved in the litigation had a strong incentive to settle the litigation because of the costs of litigation (for both parties) and (for the defendants) the magnitude of the damages if the case is lost, the fact that the professional advisors are repeat players in the securities markets and the risk of lost reputation.<sup>137</sup>

The experience was therefore that nearly all cases in the United States settled before going to trial.<sup>138</sup> The lack of judicial determination of cases gave rise to a debate in the United States arguing that settlements do not reflect the merits of the actions commenced and, consequently, that the allocation efficiency of the regulatory system is deficient.<sup>139</sup> It has further been suggested that lawyer disseminated fear of liability arising from this litigation experience casts a harsh shadow over the due diligence process to a degree that may be overstated.<sup>140</sup>

A number of judicial developments in the United States over the last decade have acted to limit liability for prospectus misstatement (for example limitations on persons who can be sued under section 12(2) discussed in Chapter 3 and the “bespeaks caution” doctrine discussed in Chapter 6) and can be seen as a judicial reaction to the spiralling incidence of litigation.<sup>141</sup>

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<sup>134</sup> For example section 12(2) of the *Securities Act*, Rule 10b-5 promulgated under the *Securities Exchange Act*, fraud, RICO (Racketeer Influenced and Corrupt Organizations Act) liability and state equivalents.

<sup>135</sup> By way of illustration see the facts of the cases cited in footnote 125 above.

<sup>136</sup> Summary judgment is a court mechanism to resolve preliminary issues of law in advance of a trial of the facts.

<sup>137</sup> See *Alexander (1991)* at 530-61.

For senior management that are joined it is a rational decision to use corporate funds to settle the case rather than risk dissipating personal funds if the case is lost - see *Brown (1998)* at 1 - 4.

<sup>138</sup> Research by J. Grundfest & M. Perino “*Ten Things We Know and Ten Things We Don’t Know About the Private Securities Litigation Reform Act of 1995*” (cited in J. Donnan “*Class Actions in Securities Fraud in Australia*” (2000) 18 C&SLJ 82 at footnote 44) suggests that 87.6% of class actions between April 1988 and September 1996 settled and the remainder were resolved through motions to dismiss or voluntary dismissal. In *Alexander (1991)* at 498 it was estimated that less than 5% of litigated cases were resolved by trial judgments.

<sup>139</sup> See *Alexander (1991)*; *Jennings (1993)*; *Seligman (1995)*; *Bohn & Choi (1996)*; *Langevoort (2000)* at 53-4. For a contrary view see *Marino & Marino (1995)* at 142 (noting large settlements distort mean statistics).

<sup>140</sup> See *Langevoort (2000)* at 46 and D.C. Langevoort & R.K. Rasmussen “*Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*” (1997) 5 S Cal Interdisc LJ 375 at 437.

<sup>141</sup> See *Langevoort (2001)* at 31.

Further, in 1995 the *Private Securities Litigation Reform Act* was passed with the objective, among other things, of curbing some of the perceived excesses of the United States litigation system.<sup>142</sup> At the time of writing it is unclear if that legislation has led to any diminution in the incidence of litigation having regard to the institutional factors that now exist in the United States to encourage securities law class actions.<sup>143</sup> However, it is clear that the amendments have imposed a much more rigorous regime in terms of the requirement to establish a viable case by requiring that the plaintiff plead with particularity facts to establish that the defendant acted with the required state of mind.<sup>144</sup>

In recent years to SEC has been sensitive to criticism that the fundraising disclosure requirements are overextensive, particularly as those requirements interact with periodic disclosure obligations imposed under the *Securities Exchange Act 1934*, resulting in draft proposals for change.<sup>145</sup> However, in conducting that review the SEC has endorsed the continuing approach of imposing in *terrorem* liability through section 11.<sup>146</sup>

A final point worth noting for the purposes of comparative analysis is that it has long been recognised that the United States federal securities laws have ceased to be a straightforward

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Having regard to the very different experience in Australia to date that contrast should be borne in mind when assessing the attractiveness of some of that United States case law to Australia.

<sup>142</sup> For a description of the background see J. Avery “*Securities Litigation Reform: The Long & Winding Road to the Private Securities Litigation Reform Act of 1995*” (1995) 51 *Bus Law* 335.

<sup>143</sup> A debate to this effect rages in the academic material - see B.C. Gibney “*The End of the Unbearable Lightness of Pleading: Scierer After Silicon Graphics*” (2001) 48 *UCLA L Rev* 972; N.M. Briski “*Pleading Scierer under the Private Securities Litigation Reform Act of 1995: Did Congress eliminate recklessness, motive and opportunity?*” (2000) 32 *Loyola Uni Chi LJ* 155; J.S. Colesanti “*The Private Securities Litigation Reform Act of 1995: Did the ‘Rushed Debate’ Really Spell The End of Securities Claims and RICO?*” (1998) 26 *Sec Reg LJ* 139; W.S. Lerach “*The Private Securities Litigation Reform Act of 1995-27 Months Later*” (1998) 76 *Wash Uni LQ* 597; J.C. Coffee “*The Future of the Private Securities Litigation Reform Act; or, why the fat lady has not yet sung*” (1996) 51 *Bus Law* 975.

It has been suggested that the cases that do survive the preliminary hurdles are likely to be more difficult to dismiss before trial, which when coupled with the incentives to settle discussed above which are unchanged, means that such suits will lead to correspondingly larger settlements - see *Brown (1998)* at 1 - 40.

<sup>144</sup> See *In Re Silicon Graphics Inc Securities Litigation* 183 F 3d 970 (1999 9th cir) and *Novak v Kasaks* 216 F 3d 300 (2000 2d Cir) (both cases demonstrate a much heightened standard of pleading as compared to the position before the adoption of the 1995 legislation). For a more moderate approach in other circuits see cases such as *Greebel v FTP Software, Inc* 194 F 3d 185 (1st Cir 1999). *In Re Advanta Corp Securities Litigation* 180 F 3d 525 (3rd Cir 1999); *Phillips v LCI International Inc* 190 F 3d 609 (4th Cir 1999).

The changes to the procedural requirements as to pleading apply to the *Securities Exchange Act 1934* (Rule 10b-5 claims in particular) rather than the *Securities Act 1933*. Other changes were made, for example, to restrict the application of the RICO statute (originally promulgated to curb organised crime) to securities law litigation (amendment to section 1964(c) of the RICO statute).

One impact of the heightened pleading standards applicable to fraud claims is an increase in claims based on section 11 - see *Curnin & Ford (2001)* at 155 - 6.

<sup>145</sup> Culminating in the so called 1998 “Aircraft Carrier” SEC rule proposals - Proposed Securities Act Release No 7606A.

<sup>146</sup> *Ibid* at 160.

statutory regime, easily accessible by anyone other than securities lawyers.<sup>147</sup> For over a decade from the mid-1960s the American Law Institute worked on a simplification and codification of the United States Securities laws for submission to the federal government.<sup>148</sup>

The draft legislation was finalised in 1978 but never received sufficient political support for adoption. The *ALI Federal Code* does however provide an invaluable reference point for comparative analysis, particularly in the area of sanctions for prospectus misstatement, having regard to the considerable time and effort that had gone into its preparation.<sup>149</sup>

### The Canadian Experience

Securities regulation had developed in a more ad hoc fashion in Canada than in many other jurisdictions because companies and securities legislation and the securities exchanges in Canada are regulated at the provincial levels of government.<sup>150</sup> The leading securities exchange is the Toronto Stock Exchange, regulated by the Ontario Securities Commission.<sup>151</sup>

Prior to the mid 1960s the history of Canadian prospectus legislation followed the English experience, much in the same way as Australia.<sup>152</sup> However, following a major Ontario review of the securities laws in the Kimber Report of 1965,<sup>153</sup> Canadian securities legislation now closely follows the structure of the US securities laws. This is particularly marked in the prospectus area where the legislation follows section 11 of the *Securities Act* in most key respects.<sup>154</sup> In addition, over the last three decades the Canadian courts have strongly endorsed a judicial approach that

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<sup>147</sup> See the concerns set out in *Cohen (1966)*. Professor Loss has said “it is not easy to think of any field in which so much law - and lore - has been built on so flimsy a statutory base” - L. Loss “Introduction: *The Federal Securities code - Its Purpose, Plan and Progress*” (1977) 30 Vand L Rev 315 at 315.

<sup>148</sup> The objectives of the *ALI Federal Code* were to simplify the complexity of the legislation, eliminate duplication of regulation and to increase the efficiency of the legislation - at XIX.

<sup>149</sup> See the description in Loss *Ibid*. Professor Loss was the “Reporter” to the project.

<sup>150</sup> Each of the ten provinces and two territories of Canada have their own securities legislation. As such, Canada has shared similar constitutional impediments to the development of its securities laws to Australia (perhaps more so).

<sup>151</sup> Typically compliance with the securities legislation of any of the provinces and territories will be sufficient to meet the statutory requirements of all.

<sup>152</sup> See description in *Johnston & Rockwell (1998)* at 15-21.

<sup>153</sup> “*Report of the Attorney General’s Committee on Securities Legislation in Ontario*” (1965, Toronto, Queens Printer).

<sup>154</sup> See for example the approach adopted in relation to the 1987 British Columbia legislation in the analysis in *Thompson (1988)*.

reflects the jurisprudence of the United States courts because of the close analogue between their respective securities laws.<sup>155</sup>

However, in common with other Commonwealth countries, there is little case law record of prospectus liability actions in the Canadian context. This is so despite some evidence of prospectus misstatement and fraud in the Canadian environment of world class proportions where fundraising is concerned, particularly involving the formation of mining companies.<sup>156</sup>

Despite comprehensive securities legislation, the effectiveness of the Canadian regime continues to struggle through the provincial system of regulation and a lack of co-ordinated national regulatory bodies.<sup>157</sup> The key reason for the lack of a civil enforcement record in Canada would seem to be the failure to facilitate the availability of cost-effective enforcement remedies.<sup>158</sup>

### Other Commonwealth Countries

Of the other countries with developed securities markets that come from a Commonwealth background there is a strong similarity with the English antecedents. However, other countries have tended not to contemplate any significant modernisation of their prospectus liability rules in the last few decades.<sup>159</sup>

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<sup>155</sup> See *Pacific Coast Coin Exchange of Canada Ltd v Ontario Securities Commission* 80 DLR (3d) 529 (1977) discussed in *Simmonds* (1979) at 644-5.

<sup>156</sup> The first comprehensive modern securities legislation, the *Ontario Securities Act* 1945 arose from findings of the “*Report of the Royal Ontario Mining Commission*” (1944) (full disclosure in prospectuses was recommended).

In the last decade the Bre-X mining promotion scandal was possibly the most notorious example of securities fraud anywhere in the world - see *Johnston & Rockwell* (1998) at 14 and 337-343.

<sup>157</sup> See *Johnston & Rockwell* (1998) at Chapters 16-17.

<sup>158</sup> See *Simmonds* (1979) at 664 and 667-9. The key difficulties are said to be the difficulty of discovering defects, the expense of bringing suit (particularly if the loss is relatively small) and investor apathy (at 664).

<sup>159</sup> The position in some of the key Commonwealth jurisdictions is as follows:

In New Zealand the fundraising liability provisions are contained in Part II of the *Securities Act* 1978, with civil liability (section 58) in the traditional terms of the English antecedent. For a description of the New Zealand fundraising provisions see P. Fitzsimons “*The Public Offering of Securities in New Zealand*”, Chapter 12 of G. Walker (editor) “*Securities Regulation in Australia and New Zealand*” 2nd Edition, 1998, LBC Information Services.

In Hong Kong the fundraising liability provisions are contained in the *Companies Ordinance* (CAP 32), with civil liability (section 40) and criminal liability (section 40A) in the traditional terms of the English antecedent (for foreign incorporated companies replicated in Part XII). Hong Kong has traditionally passed copycat legislation to England, even through that legislation may have suspect relevance to local conditions because of differing cultural considerations - see criticism in B. M. Ho “*Rethinking the System of Sanctions in the Corporate and Securities Law of Hong Kong*” (1997) 42 McGill LJ 603. There is no meaningful precedent available in relation to the Hong Kong legislation. This follows from a tradition of courts not delivering written opinions and a cultural hesitancy among Chinese of resolving disputes through litigation - see Note (J. F. Daniels) “*Comparing US and Hong Kong Public Offering Regulation: How Cost Effective is China’s Primary Capital Market?*” (1996) 69 S Cal L Rev 1821 at 1833 - 4.

In these countries there is also no meaningful case law on the applicable prospectus liability provisions.<sup>160</sup>

### The EU Initiatives

The members of the European Union have undertaken considerable work over the last 20 years in an endeavour to harmonise the regulation of securities markets within the EU. The objective of the activities in this area has been to harmonise the disclosure rules of EU members and to accord mutual recognition within the EU for disclosure documents. These objectives became a reality within the EU in the early 1990s, at the same time as Australia adopted its *Corporations Law*.<sup>161</sup>

In the common law jurisdictions of Europe the offering of securities had historically tended to be unregulated and there tended to be an absence of special liability provisions for prospectus misstatement.<sup>162</sup>

The primary EU directive<sup>163</sup> is the Listing Particulars Directive<sup>164</sup> that regulates disclosure requirements needed for the admission of securities to trading on an EU securities exchange. The Prospectus Directive governs disclosure requirements for public offers of securities within the EU.<sup>165</sup> If an issuer complies with the requirements of the Listing Particulars Directive there is no need to comply with the requirements of the Prospectus Directive.<sup>166</sup> Compliance with the disclosure requirements of one member state results in compliance with the requirements of other member states.<sup>167</sup>

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From 22 January 2001 Singapore has moved from a disclosure and liability regime that followed the English system to one that almost completely replicates the new Australian regime. The *Companies Act* (CAP 50), as amended by the *Companies (Amendment) Act 2000*, adopts Australia's general disclosure standard (section 45) as well as its criminal (section 56) and civil (section 55) liability regimes.

<sup>160</sup> In the New Zealand context there is a small body of useful precedent being notable cases such as *Bundle v Davis & Ors* [1932] NZLR 1097 and *R v Rada Corporation Ltd & Ors* (1990) 5 NZLC 96,413 discussed in chapter 7.

<sup>161</sup> For discussion see *Warren I* (1990), *Wolff* (1991), *Reid & Ballheimer* (1991); Note (A. Fama & S. J. Im) "Recent Securities Regulations in the European Community and the Integration of European Capital Markets" (1991) 32 Harv Int L J 553.

<sup>162</sup> For example, at the time of adoption of the EU directives on capital raising, of the 12 EU member states, only 5 required the preparation of a prospectus in connection with a public offering - see *Warren I* (1990) at 34 (footnote 86).

<sup>163</sup> Directives are legislative mandates to EU member states requiring the enactment of domestic legislation within a specified period - Article 189 of the *Treaty of Rome* (1957).

<sup>164</sup> Council Directive 80/390 "Co-ordinating the Requirements for the Drawing Up, Scrutiny & Distribution of the Listing Particulars to be Published for the Admission of Securities to Official Stock Exchange Listing" (as amended by 82/148 and 90/211) (the "Listing Particulars Directive").

<sup>165</sup> Council Directive 89/298 "Co-ordinating the Requirements for the Drawing Up, Scrutiny and Distribution of the Prospectus to be Published When Transferable Securities are Offered to the Public" (the "Prospectus Directive").

<sup>166</sup> Council Directive 90/211.

<sup>167</sup> Council Directive 87/345.

The general disclosure standard required by both the Listing Particulars Directive and the Prospectus Directive is disclosure, having regard to the nature of the issuer and the securities concerned, necessary to enable investors and their investment advisors to make an informed assessment of the assets and liabilities, financial position, profits and losses and prospects of the issuer and the rights attaching to the securities.<sup>168</sup> This standard of disclosure is also the genesis of the *Corporations Act* standard of disclosure.

The primary continuing difficulties arising in the EU with the uniform disclosure standard is the widely differing accounting standards that apply for purposes of financial disclosures. Further it is left to each member state to determine what is an offer to the public for purposes of requiring disclosure under the Prospectus Directive.<sup>169</sup>

However a more fundamental difficulty for purposes of this dissertation is that the EU Directives make no attempt to dictate to member states the sanctions that should apply to non-compliance with the directives.<sup>170</sup> As such, this is left to each member state, with widely varying approaches to regulation.

### Other Significant Markets

The only significant securities markets outside the jurisdictions outlined above are the markets of Japan, China and Switzerland.

Japan has adopted a system of regulation based directly on the United States model.<sup>171</sup> There is no experience of enforcement of the prospectus liability provisions.

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<sup>168</sup> *Listing Particulars Directive* article 4, paragraph 1; *Prospectus Directive* article 11, paragraph 1.

In 2001 a new listing particulars and prospectus directive was proposed to deal with certain of the deficiencies identified below - "Proposal for a Directive of the European Parliament and of the Council on the Prospectus to be published when securities are offered to the public or admitted to trading" 2001/9999 (30 May 2001) (the "Proposed Directive"). In addition to the specification of when a public offer arises (see below) the key initiative of the Proposed Directive is to incorporate detailed content requirements in aid of the general disclosure standard (see Article 5 and Annex 1).

<sup>169</sup> For discussion see *Reid & Ballheimer* (1991) at 129-130 and *Warren I* (1990) at 20.

On the other hand, the Proposed Directive addressed this issue (Article 3).

<sup>170</sup> For discussion see *Warren I* (1990) at 49 and *Warren 2* (1990) at 212.

This continues to be the case with the Proposed Directive.

<sup>171</sup> *The Securities and Exchange Law 1948* (Japan). For a description see *Cohen* (1989) at 259-261.

In China there have been significant moves in recent years to develop a system of securities law that reflects international practices. However, the fundraising liability provisions are relatively unsophisticated and of little comparative assistance. The 1999 *PRC Securities Law* requires fundraising documents to be truthful, accurate and complete. Professional organisations and persons involved in the preparation of the documents must strictly perform their statutory duties and warrant the truthfulness, accuracy and completeness of the documents.<sup>172</sup>

Switzerland has a largely unregulated approach to security offerings with Swiss banks controlling the offering and distribution process.<sup>173</sup> Once more there is little in the system of regulation that assists in an assessment of an appropriate regulatory model.

To the extent other jurisdictions have adopted models of securities regulation to control the offering of securities markets, the United States model has proven influential.<sup>174</sup>

### **Moves for Multijurisdictional Harmonisation**

Over the last decade there have been significant efforts to harmonise the prospectus disclosure laws in the key jurisdictions having regard to the increasing incidence of global offerings.

At one level the harmonisation of the operation of international securities laws involves consideration of whether foreign offerings can be exempted from domestic prospectus laws, at least so that institutional investors can participate in such offerings. However from a longer term perspective it is considered that a broader approach is required to permit global standards to be developed. In the mid-1980s the US Securities and Exchange Commission proposed two alternative ways to overcome the problem.<sup>175</sup> The first proposal was to permit reciprocity where participating jurisdiction accept one another's domestic standards for a prospectus. The second approach is a common prospectus approach where regulators agree on common disclosure standards.

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<sup>172</sup> Article 13 of the PRC Securities Law (Promulgated by the PRC State Council on 29 December 1998). The liability regime provides for fines and general criminal liability without specifying a culpability requirement - Article 176.

<sup>173</sup> See *Cohen (1989)* at 259-261.

<sup>174</sup> See for example the description of the Israeli modernisation of prospectus laws in moving from an English to United States approach to securities regulation in J.H. Gross "Civil Liability for the Contents of the Prospectus in Light of the New Israeli Securities Law" (1973) 36 MLR 600.

<sup>175</sup> *Securities Act* Release No. 6,568 promulgated by the SEC on 28 February 1985.

Clearly over the last decade the reciprocity approach has been the favoured alternative, being a more realistic approach to resolving the political issues involved.<sup>176</sup> Even so, issues such as harmonisation of accounting practices remain difficult issues requiring further work.

For purposes of this dissertation the interesting issue is to determine how sanctions will apply to the development of multijurisdictional issues.<sup>177</sup> The survey discussed above illustrates key cultural distinctions between the United States and other markets in terms of the enforcement of sanctions, even if there is a marked similarity between the nature of the sanctions themselves. These harmonisation efforts have failed to address the issue of different sanction regimes in each market.<sup>178</sup>

Recently, there has been the development of a theoretical argument that the continuing convergence of regulatory models will result in an inevitable acceptance of the primacy of the United States securities law model.<sup>179</sup> However, that literature seems quite egocentric in its focus and, as this dissertation will demonstrate, the complexities and flaws of the United States system does not suggest an inevitable acceptance of all aspects of the United States model, at least in the area of prospectus misstatement.<sup>180</sup>

## 1.5 THE GENESIS OF THE CORPORATIONS ACT AND ITS ONGOING REFINEMENT

The Australian experience with prospectus regulation is clearly reflective of the global developments summarised in the preceding section. As can be expected, Australian prospectus regulation has a genesis from the English legislation. However, over the last two decades, Australia has increasingly gone its own way on the reform of its prospectus laws. With the enactment of the *Corporations Law*, there has been a dizzying rate of change in regulation of the

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<sup>176</sup> See *Warren 2* (1992) at 191-3; *Karmel* (1990) at 8-10; P. Merloe "Internationalisation of Securities Markets: A Critical Survey of US and EEC Disclosure Requirements" (1986) 8 *Jnl of Comp Bus & Capital Market Law* 249.

<sup>177</sup> In its 1985 release the SEC had recognised that differences in liability provisions were one of the key problems to the development of harmonisation arrangements - see *Securities Act* Release 6,568.

<sup>178</sup> See *Steinberg & Michaels* (1999) at 262.

<sup>179</sup> See for example J.C. Coffee "The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications" (1999) 93 *NW U L Rev* 461; H. Hansmann & R. Kraakman "The End of History for Corporate Law" (2001) 89 *Geo L J* 439; M. Fox "The Political Economy of Statutory Reach: US Disclosure Rules in a Globalizing Market for Securities" (1998) 97 *Mich L Rev* 696.

<sup>180</sup> For a similar thesis see K.M. Luck "The End of History for Corporate Governance or Just Another Moment in Time?" (2001) 19 *C&SLJ* 305.

prospectus area. What is interesting to observe is where these changes have come from and what they have sought to achieve.

### Historical Development

In the second half of the Nineteenth century each Australian colony had adopted legislation to facilitate the formation of limited liability companies copied from the then English Companies Act.<sup>181</sup> Similarly Australian prospectus regulation developed at the turn of the Twentieth century as part of the companies legislation copied on the English experience.<sup>182</sup> Following federation in 1901, the Australian states continued to have responsibility for company matters, but looked to England for guidance on developments, particularly in the fundraising area.<sup>183</sup>

The lack of uniformity of companies legislation in each state had been perceived to be a difficulty for some time. In 1961 this position was resolved by each Australian state enacting the same form of legislation, the so called *Uniform Companies Act* for that state.<sup>184</sup>

It was not until the 1970s that meaningful independent inquiries into the operation of particular aspects of the securities laws were commissioned with a view to adopting laws relating to the offering of securities that were not simply derivative of the then English legislation.

In 1967 the Eggleston committee was established by the states and the Commonwealth to review investor protection issues following some significant failures of finance companies in the mid 1960s. The Eggleston committee reported in 1970.<sup>185</sup> While the lasting impact of the Eggleston

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<sup>181</sup> See R. McQueen “*Limited Liability Company Legislation: The Australian Experience*” (1991) 1 Aust Jnl of Corp L 22 at 24-7.

<sup>182</sup> For example, the *Companies Act 1896 (Victoria)* closely followed the recommendations of the Davey Committee in 1895 - see R. McQueen Ibid at 37.

<sup>183</sup> In New South Wales see the *Companies Act 1899* (section 66 copies the 1867 *Material Contracts Act*) and the *Companies Act 1936* (section 140 copies the civil liability regime of the *UK Companies Act 1929*).

In Victoria see the *Companies Act 1928* (civil liability in section 92 and criminal liability in section 87) and the *Companies Act 1958* (civil liability in section 42 and criminal liability in section 43).

In the other states the provisions of the English companies legislation was adopted in South Australia in 1934; Queensland in 1931; Tasmania in 1920 and Western Australia in 1893.

There was a perceived policy objective in the close similarity of the English and Australian legislation in the early Twentieth century, being to facilitate integration between Australian and English business - see R. McQueen Ibid at 42-3.

<sup>184</sup> The prospectus liability provisions were derivative of the English statute at that time - see section 46 (civil liability) and section 47 (criminal liability) of the *Companies Act 1961* of each Australian state.

The primary objective of the *Uniform Companies Act* was to achieve harmonisation of the legislative scheme rather than to initiate law reform - see R. McQueen Ibid.

<sup>185</sup> “*Company Law Advisory Committee to the Standing Committee of Attorney’s General*”, the Parliament of the Commonwealth of Australia, Parliamentary Paper 22 (1970). The brief of the Eggleston committee was to inquire into and report on the extent of the

committee has been in the area of takeovers, a significant review of the fundraising provisions was also undertaken as part of that process.<sup>186</sup> The main focus of the Eggleston committee was to identify deficiencies in the concept of offer to the public that was the pre-condition to the obligation to prepare a prospectus, the role of registration of prospectuses and a review of the checklist of required disclosures in a prospectus. However, the committee report also contained a proposed redraft of the prospectus provisions that included a much simpler and streamlined drafting of the liability regime.<sup>187</sup>

Further, in 1970 a more general review of Australia's securities laws was established by the Commonwealth Senate, known as the Rae committee.<sup>188</sup> Following the appointment of that committee the infamous minerals boom and bust of 1970/1 occurred, with the result that the committee conducted detailed inquiries into the reasons for particular corporate collapses and the excesses that were perceived to have occurred. As a consequence, a final report was not released until 1974.<sup>189</sup> While the primary recommendations related to the regulation of stock exchanges and sanctions for market manipulation, insider trading and short selling, a significant review was undertaken in relation to prospectus regulation. The Rae committee observed significant deficiencies in the system of regulation as it applied to initial public offerings.<sup>190</sup> The primary solution proposed in relation to those failings was the establishment of a national regulator and better enforcement, rather than further prospectus legislation.

In 1973, with the appointment of the first Labor Government in a generation, a significant rewrite of the companies and securities laws was commissioned by the Commonwealth Attorney-

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protection afforded to the investing public by the existing provisions of the companies legislation and to recommend additional protections (at para 1).

<sup>186</sup> Eggleston committee "Fifth Interim Report October 1970 on the Control of Fundraising, Share Capital and Debentures" (Parliamentary Paper No. 99, 1971).

<sup>187</sup> Ibid at paragraph 61 and proposed section 46 in Appendix A.

The legislation proposed a single standard of liability and defences for criminal and civil liability (as is now largely reflected by the *Corporations Act*). The liability regime was proposed to extend to directors, proposed directors, promoters, persons authorising or causing the issue of the prospectus and experts. The due diligence defence was simplified to a simple "reasonable grounds" defence (and, for example, contained no expertisation defences).

The formulation of the persons responsible for prospectus misstatement and the scope of the damages remedy as proposed by the Eggleston committee suffers many of the deficiencies identified in Chapters 2 and 3.

<sup>188</sup> "Australian Securities Markets and their Regulation: Report from the Senate Select Committee on Securities and Exchange" (AGPS, 1974).

The terms of reference of the committee was to establish a national securities commission and to deal with manipulation and injurious practices relating to dealings in shares.

<sup>189</sup> For an account see R. Baxt "The Rae Report - Quo Vadis" 1974, Butterworths.

<sup>190</sup> See the case studies in Chapter 11 of the Rae committee report. See also the criticism of the role of brokers in these transactions (for example at 1.8 and 1.9 and 10.105-110).

General's department resulting in the development of draft legislation that proposed federal securities laws and a single regulatory body.<sup>191</sup> The draft legislation was prepared following an extensive analysis of comparative jurisdictions and reflected the recommendations of the Eggleston committee.<sup>192</sup> The legislation proposed a rewrite of the prospectus liability rules that was strongly influenced by section 11 of the United States *Securities Act*.<sup>193</sup> The draft legislation addressed many of the deficiencies in the current legislation that are identified in this dissertation. Unfortunately the legislation was not enacted following the dissolution of the Labour government in 1975. Since that time regard has not been had to the draft legislation in formulating law reform proposals in relation to prospectus misstatement. That is a shame having regard to the strong policy basis and comparative analysis reflected in the legislation.

With the change of government in 1975 the recommendations of the Eggleston committee had still not been acted upon. The new conservative government did not favour the creation of a national regulator as recommended by the Rae committee but did favour the creation of national regulation under a co-operative model of state legislation. The result was the 1981 *Co-operative Companies Code* that established new uniform legislation in each Australian state and a new national regulator, the National Companies & Securities Commission (NCSC). However, the prospectus registration and liability regime was largely untouched from the 1961 *Uniform Companies Act*. That was a backward step as compared to the innovative approach reflected in the draft 1974 legislation.

### SIRC Committee

In the mid-1980s, the National Companies & Securities Commission became concerned that the fundraising provisions of the companies legislation might no longer be appropriate to evolving market conditions and in providing appropriate measures for investor protection.<sup>194</sup> In May 1986 the NCSC established the *SIRC Committee* to advise it on the adequacy of the then current law.<sup>195</sup>

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<sup>191</sup> The *Corporations and Securities Industry Bill 1974*.

<sup>192</sup> See paragraph 5 of the *Explanatory Memorandum for the Corporations and Securities Industry Bill 1974*. In addition regard was had to a report commissioned from Professor Loss of the United States ("*Proposals for Australian Companies and Securities Legislation. Comments from the American Experience*"). The Australian approach therefore had much in common with the approach adopted in England in the early 1960s by the Jenkins committee.

<sup>193</sup> Section 171 of the *Corporations and Securities Industry Bill 1974*. For example, the legislation proposed underwriter liability and a specification of the measure of damages for prospectus misstatement.

<sup>194</sup> In 1982 the NCSC had released a redraft of the prospectus provisions of the companies legislation ("*Offers of Securities by Corporations*") which reflected a refinement of existing provisions rather than any fundamental changes. The 1982 NCSC redraft reflected in large part the recommendations of the 1971 Eggleston committee. It did not reflect the work contained in the *Corporations and Securities Bill 1974*.

Unfortunately, the work of the *SIRC Committee* was overtaken by the general proposals announced in 1987 for the development of new Commonwealth companies and securities laws. It was determined by the Commonwealth Government that reform of the fundraising provisions should form an integral part of that initiative.

Having regard to these considerations, the overheated markets that existed in early 1987 and the stock market crash of October 1987, the *SIRC Committee* decided to release an interim report in August 1988. The *SIRC Report* was prepared before the contents of the *Corporations Bill* were known, and there was no attempt to compare the two.<sup>196</sup> Neither the National Companies & Securities Commission nor the Ministerial Council considered the interim report in any detail. The hope of the *SIRC Committee* in releasing its interim report was to contribute to public debate on the fundraising provisions. A final report was never released.

### **Corporations Law**

The genesis of the *Corporations Law* was an April 1987 report of the Senate Standing Committee on Constitutional & Legal Affairs, which recommended that the Commonwealth parliament should enact comprehensive legislation covering the field of companies and securities regulation that was then regulated by the co-operative scheme.<sup>197</sup>

The co-operative scheme was perceived to have the following inherent structural defects:<sup>198</sup>

- Lack of accountability to any particular parliament in view of the involvement of Commonwealth and State Governments in the co-operative scheme
- Difficulties with the division of functions between the NCSC and its state and territory delegates leading to administrative inefficiencies, unnecessary duplications and additional costs.

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<sup>195</sup> The objective of the *SIRC Committee* was to critically analyse the characteristics of the then system of raising funds by the private sector for security issues and trading in order to determine whether the system effectively met the needs of investor confidence and capital market efficiency and to recommend appropriate changes.

<sup>196</sup> See Preface to *SIRC Report*. The *SIRC Report* was released after the *Corporations Bill 1988* was first introduced in parliament (May 1988) - see below. Therefore there was publicly released two reform proposals that were largely inconsistent.

<sup>197</sup> See Senate Standing Committee on Constitutional and Legal Affairs "*The Role of Parliament in Relation to the National Companies Scheme*" (1987, AGPS).

<sup>198</sup> For a summary, see paragraph 11 of the Explanatory Memorandum to the *Corporations Bill 1988*.

- Burdensome and lowest common denominator legislation because of the over-involvement of scheme administrators in legislative policy development, leading to frequent legislative changes and increasing the burden of unnecessary business regulation.

The reforms to prospectus liability proposed by the *Corporations Bill* 1988 were far reaching. However, those reforms did not follow any apparent detailed public review process of the then operation of the prospectus laws or reflect the work of the review committee's discussed above.<sup>199</sup> An immediate observation that can be made of the law reform record in Australia between 1970 - 1990 is that there was no shortage of well-intentioned reviews of the prospectus regime of the legislation. However, for a variety of reasons the detailed work and recommendations of the review committees' seem to have been marginalised and overlooked through political developments.<sup>200</sup> This suggests a serious deficiency in the approach adopted as part of the reform process.

The *Corporations Bill* was introduced into Commonwealth parliament on 25 May 1988. Various amendments to the bill were introduced on 28 September 1988.<sup>201</sup> The bill was then referred to a Senate Joint Select Committee to report in April 1989.

The haste with which the fundraising provisions had been developed led one commentator to recommend no change to the predecessor companies code provisions pending an early revision.<sup>202</sup>

### Amending Legislation

The ambiguities and anomalies created by the rewrite of the fundraising provisions gave rise to the need for a number of pieces of amending legislation. No less than five amending pieces of legislation were enacted in the first five years following the enactment of the *Corporations Law*, in

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<sup>199</sup> A commentator at the time described the changes to the fundraising provisions as reflecting "a whiff of revolution and gunshot" - R.J. Vann "Fundraising Under The Proposed Australian Corporations and Securities Legislation" (1988) 13 Butterworths Company Law Bulletin at para 298.

<sup>200</sup> In particular the work of the *SIRC Committee* was well thought out and had a strong policy basis and, for that reason, will be noted as a contrast to the *Corporations Act* provisions in this dissertation - for a similar observation see *Austin (1988)* at 116.

<sup>201</sup> The amendments reflected some of the *SIRC Report* recommendations that had been released a month earlier. However, it was noted by some that the amendments were less satisfactorily than the *SIRC Report* proposals - See *Austin (1989)* at 88.

<sup>202</sup> See *Austin (1989)* at 80.

many cases rectifying substantial deficiencies or making substantial changes to the structure of Chapter 6.<sup>203</sup>

In addition, in 1991 the *Loneragan Committee* was commissioned to make recommendations on possible changes to the legislation. The objective of the *Loneragan Committee* was to review the prospectus provisions and to recommend any reforms that would facilitate the efficient preparation of prospectuses without compromising investor protection. However, the recommendations in the March 1992 report of the *Loneragan Committee* were not directly acted upon in any significant legislative amendments.

### **Simplification Task Force**

In October 1993, the *Simplification Task Force* was established by the Attorney General to simplify the structure of the *Corporations Law* and to rewrite certain parts of the *Corporations Law* in plain English.<sup>204</sup> The mantra of the *Simplification Task Force* was to simplify the structure of the law.

Stage 3 of its work (commencing in 1995) involved a review of the fundraising provisions of the *Corporations Law*.<sup>205</sup> The Attorney General announced that a review of the areas of fundraising and takeovers would be the first areas of focus in commencing work on the simplification of the laws relating to securities. It was noted that major reforms to fundraising had been incorporated in the *Corporations Law* and that no changes to the fundamental outcomes of those changes, such as to the content of disclosure, were contemplated.<sup>206</sup> Instead the focus would be on dealing with difficulties with the practical operation of the fundraising provisions, such as those identified by the *Loneragan Committee*.

In addition, in June 1995 the Attorney General requested that the *Simplification Task Force* report on the application of section 52 of the *Trade Practices Act* to fundraising.<sup>207</sup> The

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<sup>203</sup> *Corporations Legislation Amendment Act 1991* (No 110 of 1991); *Corporations Legislation Amendment Act ((No 2) 1991* (No 201 of 1991); *Corporate Law Reform Act 1992* (No 210 of 1992); *Corporate Law Reform Act 1994* (No 31 of 1994); *Corporations Legislation Amendment Act 1994* (No 104 of 1994).

<sup>204</sup> The task force comprised a commercial lawyer from the private sector, a plain English expert, a legislative drafter and a policy advisor from the Attorney Generals Department. The task force was assisted by a consultative group comprising private sector users of the *Corporations Law*.

<sup>205</sup> Corporations Law Simplification Program “*Plan of Action Stage 3*” April 1995 (Attorney General’s Department). Announced by the Attorney General, Mr Michael Lavarch, on 6 April 1995 by press release 27/95.

<sup>206</sup> Attorney General’s Press Release 27/95.

<sup>207</sup> News Release issued by the Attorney General (Mr Michael Lavarch) on 2 June 1995 (No. 52/95).

Attorney-General noted that the potential application of the *Trade Practices Act* to prospectuses had been discussed in the *NRMA Case*<sup>208</sup> and was one of the most topical issues in the regulation of securities markets.<sup>209</sup>

The result of the work of the *Simplification Task Force* on fundraising was the *Simplification Task Force Report on Fundraising*, released in November 1995.

The report recommended a rewrite of Part 7.11 and Part 7.12 of the *Corporations Law*, as it applied to fundraising, in plain English as well as certain fundamental changes, including a rewrite and simplification of the operation of the liability provisions. The report further recommended that section 52 of the *Trade Practices Act* be excluded from operation in relation to fundraising.

The *Simplification Task Force* was disbanded following the change of government in Australia in September 1996. At the time of the change of government the *Simplification Task Force* had been conducting workshops with the business community with a rewritten fundraising chapter of the *Corporations Law*, but that legislation was never released for general public comment.

## CLERP

In March 1997 the new Treasurer announced an initiative “to implement the most wide ranging reform of Australia’s corporate law to boost economic activity, small business and jobs”<sup>210</sup>, including policy reforms in the area of fundraising.<sup>211</sup>

The primary initiative in relation to fundraising was said to be to make access to capital easier for small business.

In October 1997, the *CLERP Fundraising Paper* was released. The *CLERP Fundraising Paper* contained 21 reform proposals for the regulation of fundraising, including clarification of the

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<sup>208</sup> See section 5.1 discussion.

<sup>209</sup> This issue is addressed in section 5.1 of this dissertation.

<sup>210</sup> Press Release 28 issued by the Treasurer (Mr Peter Costello) on 17 March 1997.

<sup>211</sup> The other areas of proposed reform were in connection with takeovers, accounting standards, electronic commerce and a regulatory structure for financial markets and investment products.

The CLERP program reflected a shift in political power over the reform agenda from the Attorney-General’s department to the Department of Treasury.

At the same time the establishment of an advisory committee, the Business Regulation Advisory Group (BRAG), was announced to assist in the review, comprising representatives from peak business groups.

liability rules, a single due diligence defence and removal of the overlap between the prospectus liability rules and section 52 of the *Trade Practices Act*. The key reform proposals were to expand the exemptions from the obligation to prepare a prospectus available to small and medium enterprises in raising capital.<sup>212</sup>

The *CLERP Fundraising Paper* expressed the need for changes in the regulation of fundraising “in accord with a sound economic framework which is pro-business and underpins investor confidence in market integrity”.<sup>213</sup> The paper purported to support its proposals by reference to an economic analysis of competitive equity markets.<sup>214</sup>

Draft legislation was released for comment in April 1998.<sup>215</sup> The draft legislation proposed the insertion of a new fundraising chapter into the *Corporations Law*. That draft legislation closely follows the ultimate *CLERP Act* in the area of fundraising. The supporting materials argued that there was a need for new legislation by reference to policy considerations that were said would reduce the cost of fundraising but by providing appropriate levels of investor protection.<sup>216</sup>

The *CLERP Bill* was first introduced into parliament on 2 July 1998. The Explanatory Memorandum to the *CLERP Bill* claimed that the bill contained reforms designed to minimise the cost of fundraising while improving investor protection.<sup>217</sup>

It was asserted that:

“Current regulation results in long and complicated prospectuses with high costs of preparation and distribution to fundraisers. In particular, uncertainty about the liability of

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<sup>212</sup> To raise up to A\$5 million using an offer information statement, up to A\$2 million from 20 private investors and less than A\$500,000 from business angels without a prospectus. For discussion see *Grose (1999)* and *Whincop (1998)*.

<sup>213</sup> *CLERP Fundraising Paper* at 9.

<sup>214</sup> Appendix B to *CLERP Fundraising Paper*.

<sup>215</sup> Press Release of the Treasurer Mr Peter Costello No. 35 dated 9 April 1998. A period of 6 weeks were allowed for comment. Three papers describing the proposals were released at that time “*Policy Reforms*”, “*Commentary on Draft Provisions*” and “*Draft Provisions*”.

<sup>216</sup> “*Policy Reforms*” paper at page 1.

<sup>217</sup> Paragraph 1.5 of the Explanatory Memorandum to the *CLERP Bill* stated:

“The reforms will promote the operation of informed markets and, by removing unnecessary impediments to fundraising, facilitate investment which is vital to Australia’s economic performance. The reforms also seek to ensure that the fundraising rules provide an appropriate cost effective framework for capital raising by small, medium and large companies”.

However the new legislation did not demonstrate any rigour in terms of its policy basis.

On the other hand, it has been argued that an approach to the *CLERP Act* law reform process based on “analogy, intuition, small steps and interjurisdictional comparisons” is timid - *Whincop (1999)* at 12.

regime leads to excessive due diligence procedures. The current rules are a clear barrier to fundraising by small and medium size enterprises”.<sup>218</sup>

The Explanatory Memorandum to the *CLERP Bill* asserted that this issue would be addressed by permitting the use of short form prospectuses, removing uncertainty as to liability of the parties involved in prospectus preparation and undertaking measures to assist small and medium enterprises to raise capital.<sup>219</sup>

In introducing the *CLERP Bill* into parliament the Minister for Financial Services and Regulation expressed a similar view:

“Prospectuses are often too long and complicated and can obscure information of interest to investors. Issuers frequently complain that they are forced to burden prospectuses with unnecessary information and that prospectus costs are too high”.<sup>220</sup>

Chapter 6D of the *Corporations Law* was proclaimed to take effect from 13 March 2000.

The adoption of the *CLERP Act* was therefore introduced with a large amount of rhetoric based on increased efficiency and investor protection. This dissertation will test that rhetoric in terms of the likely impact on the effectiveness of the prospectus liability rules.

## 1.6 THE DISCLOSURE DEBATE AND THE PLACE OF LIABILITY RULES

In order to assess properly the *Corporations Act* reforms in relation to misstatement liability it is also necessary to have regard to the theoretical policy underpinnings of the legislative regime in which the liability rules operate. The Chapter 6D regime imposes a mandatory disclosure regime on a person wishing to undertake a securities offering (subject to the offering exemptions). The liability rules that interact with that mandatory disclosure regime penalise the failure to properly make the required disclosures.

Mandatory disclosure has been a topical issue in Australia over the last decade as momentum built to require widely held entities to make continuous disclosure of information relevant to investors.<sup>221</sup> On the other hand, the adoption of a new mandatory disclosure regime in the

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<sup>218</sup> Paragraph 2.24 of the Explanatory Memorandum to the *CLERP Bill*.

<sup>219</sup> Paragraph 2.27-2.28 of the Explanatory Memorandum to the *CLERP Bill*.

<sup>220</sup> *Hansard - House of Representatives*, 3 December 1998 at 12.84.

<sup>221</sup> In Australia in the early 1990s questions of the merits and disadvantages of mandatory disclosure were hotly debated in the area of continuous disclosure, ultimately resulting in the adoption of section 1001A of the *Corporations Act* (effective 5 September 1994) (from 11 March 2002 to be contained in Part 6CA of the *Corporations Act*) - see Companies & Securities Advisory Committee “*Report on an Enhanced Statutory Disclosure System*” (September 1991); M. Blair “*Australia’s Continuous Disclosure Regime: Proposals for Change*” (1992) 2 *Aust Jnl of Corp Law* 54; McEwin “*Australia’s Continuous Disclosure Regime: Some Comments*” (1992) 2 *Aust*

prospectus context, as reflected in the standard of disclosure set out in Part 6D.3 of the *Corporations Act*, and Part 7.12 of the *CL* before it, involved no lengthy debate as to the desirability, or otherwise, of mandatory disclosure rules in that context. As the preceding historical overview has established, Australia's securities laws, in common with the securities laws of most jurisdictions, have for more than a century proceeded on the basis that detailed mandatory disclosure rules are appropriate when capital is being raised. The historical mandatory disclosures rules were replaced with generally expressed disclosure rules with the enactment of the *Corporations Law*.

It is helpful to put that disclosure issue in context by making some basic observations about the theoretical policy underpinnings of mandatory disclosure rules. The orthodoxy of analysis as to the merits of mandatory disclosure rules have been the subject of reappraisal and challenge in the academic material over the last 15 years. The primary objective of this analysis will be to identify how the liability rules supporting mandatory disclosure are relevant to the debate.

### **Basic Regulatory Choices**

The first preliminary observation that can be made is that there is a range of basic regulatory choices that are available to provide investor protection in relation to public offerings

At one end of the range of possible regulatory approach to regulation would be to endorse a principle of "caveat emptor" in relation to securities offerings. Such an approach would involve the legislation leaving it to the securities markets to determine what, if any, disclosure is appropriate or is required to sell securities.

Ownership of securities is an investment alternative that involves a freely made choice by the investor. It is completely open to investors whether or not they wish to participate in the securities markets. It will be clear to all investors that risk is involved and must be traded off against possible rewards. It can therefore be said that if investors wish to pursue that investment alternative they should accept the risk of total loss, whether by virtue of business failure or by virtue of not fully appreciating or having been informed of the risks associated with the particular investment.

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Jnl of Corp Law 77; Blair (1992). At the end of 1990s, and with the tech wreck and declining prices again being a feature of the securities market, compliance with the continuous disclosure regime has again been topical.

As is illustrated by the historical overview in Section 1.4, the caveat emptor approach to regulation was rejected as an appropriate basis for the regulation of fundraising in England from the 1840s and the United States from the 1930s. However, as is discussed further below, that premise has been the subject of reassessment in recent years by certain commentators.

At the other extreme, a possible regulatory approach would be to implement “merit” legislation. As mentioned earlier, under such a regime a regulatory body would have the power to determine whether or not an offering of securities can proceed having regard to a regulatory assessment of the perceived interests of investors. The best example of merit legislation was the development of state based “blue sky” laws in the United States in the early 1900s.<sup>222</sup>

A state based assessment of the merits or otherwise of securities offerings is clearly philosophically inconsistent with capitalist principles. Investors freely make a decision to invest based on their own assessment of potential risk and return. That decision is made against the choice available to them in relation to other investment opportunities. As such, even though large numbers of investors have lost significant amounts during the boom and bust of many economic and securities market cycles (and most recently in the 2000 tech wreck), it has rarely been seriously suggested that merit legislation is appropriate for the regulation of securities offerings.<sup>223</sup> The famous quotes of Gladstone and Brandeis extracted above explain the policy basis of the orthodox view.

Alternatively, a possible middle approach to regulation is to require mandatory disclosure of certain types of information that are considered to be of assistance to investors in making an informed investment decision. That is, of course, the approach that has been adopted in relation to securities offerings in most jurisdictions including Australia, England and the United States.

### **Effects of Mandatory Disclosure**

The second preliminary observation that can be made is that from the theoretical policy perspective a mandatory disclosure regime operates on a variety of different levels.<sup>224</sup> Three key effects of a mandatory disclosure regime can be identified.

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<sup>222</sup> For discussion of the regulatory philosophy of those laws and statistical evidence suggesting some benefits from those laws in protecting investors see *Goodkind (1976)* at 106 and 123.

<sup>223</sup> For discussion in the U.S. context at the time of the introduction of the *Securities Act 1933* see *Douglas & Bates (1933)* at 172-3.

<sup>224</sup> For analysis see *Note (1963)*. That article contrasts the effectiveness of disclosure regimes as an appropriate regulatory approach in relation to the regulation of securities offerings, insider trading, voting procedures for life insurance companies, corporations, labour unions, welfare plans and election laws.

First, and most obvious in the securities law context, is the “information effect” of disclosure whereby the recipient of the disclosure receives the information, evaluates it and is able to act upon it. In this way the recipient can protect their personal interests by acting on the information (for example by choosing whether or not to invest in securities) without the necessity to resort to legal action (as, for example, would be the case if there were otherwise a non-disclosure that might give rise to misstatement liability) or without the necessity of altering the future conduct of the person making the disclosure through litigation.<sup>225</sup>

The second effect of mandatory disclosure rules can be described as the “enforcement effect”. By requiring disclosure, necessary information is provided to the recipient so as to permit later enforcement actions to be taken if a disclosure violation is subsequently established in relation to the matters disclosed. On this basis, for example, mandatory disclosure rules in the securities laws provide the ammunition for a successful legal action if a misstatement in relation to the matters that are disclosed arises.<sup>226</sup> The relevance of liability rules to facilitate the operation of the mandatory disclosure regime in this context is obvious.

The third effect of disclosure is the “public disapproval” effect. If mandatory disclosure rules require a person to provide details of a matter that will potentially subject that person to public censure, that may influence the person not to undertake that action in the first place.<sup>227</sup> A good example of the public disapproval effect in Australia has been developments in recent years to require the disclosure of related party transactions with directors and persons that exercise control over companies.<sup>228</sup> In addition, publicity itself may be used as a form of sanction where a contravention of regulation has occurred, for example where a court orders curative disclosure or public notification that there has been a breach of the law.<sup>229</sup>

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For similar analysis in the securities law context see J. Stevenson “*Disclosure to Investors*”, Chapter 6 in “*Corporations and Information - Secrecy, Access and Disclosure*” 1980, John Hopkins University Press.

<sup>225</sup> *Note (1963)* at 1274-5. This was seen to be an important objective of the *Securities Act 1933* at the time of its introduction - see *Douglas & Bates (1933)* at 172; *Anderson (1974)* at 330.

<sup>226</sup> *Note (1963)* at 1273-4.

<sup>227</sup> *Note (1963)* at 1274. See also J. Hill “*Visions and Revisions of the Shareholder*” (2000) 48 *Am Jnl of Comparative Law* 39 at 59-61.

<sup>228</sup> As encapsulated in Australian Accounting Standards Board Release AASB 1017. A more recent example of the “public disapproval” effect in many key jurisdictions is the required disclosure of executive compensation.

The United States Securities Exchange Commission has sought to modify behaviour through the public disapproval effect on many occasions. The most well known example is the required disclosure in the 1970s of payments for foreign bribes - for a description see *Coffee (1976)*.

<sup>229</sup> *Note (1963)* at 1274 at footnote 6, referring to Hart & Sacks “*The Legal Process*” (1958).

The regulation of securities offerings is particularly suited to mandatory disclosure based regulatory mechanisms as it is relatively easy to ensure adequate disclosure in the prospectus context and (subject to the debate outlined below) it is reasonable to expect investors will act on the disclosures made. This is particularly so because an investor in securities has a free choice whether or not to act on the information. Therefore, the information effect of disclosure can be considered to have advantages over other regulatory alternatives, such as merit legislation, because investors can take steps to protect their own interests.<sup>230</sup>

This analysis of the “information effect” of disclosure proceeds however on the basis that the relevant recipient of the information receives and appropriately evaluates that information. In the modern securities markets that assumption poses challenges that will be the subject of further analysis below.

### **Disclosure and the Operation of the Securities Markets**

If there is a self evident threshold issue that needs to be settled in relation to securities regulation, it is the question of how information is impounded into share prices and how the exercise of investment decisions by investors interact with the flow of information concerning securities in the securities markets. Unfortunately there appears to be no simple answer to that question.

In recent decades there has been a fundamental reappraisal of the way in which the securities markets are perceived to reflect information through the application of the economic finance theories of the “efficient market hypothesis” and “portfolio theory”. Further, in recent years there has been a revisionist response to the “pure” forms of these theories, led by the so called “noise” theorists in the United States, that has become increasingly influential in the academic literature.

In formulating the prospectus disclosure rules of the *Corporations Law* at the end of the 1980s there was no analysis of these issues. Indeed the academic assessment of the efficient market hypothesis in Australian legal circles in the late 1980s was rudimentary at best. In developing the reforms underlying the *CLERP Act*, reference was made to the language of market efficiency but, as discussed below, it can be argued that the explanation of the theoretical policy underpinnings for the reforms was poorly expressed.

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<sup>230</sup> Note (1963) at 1278-9.

A strong disclosure regime is therefore seen as a core institution supporting broadly based ownership of securities - see B.Black “*The Core Institutions that Support Strong Securities Markets*” (2000) 55 Bus Law 1565.

The existence of a relationship between the mandatory disclosure of information and securities prices is hardly startling. That has also been the orthodox approach of the courts to assessing the consequences of disclosure of information in assessing damages where there has been a misstatement.<sup>231</sup>

It follows from this analysis that if information is misstated the market generally and investors on an individual basis will wrongly factor that information into the price of the securities and the market price of the securities in question will not properly reflect the “true value” of the security. As such, there is a role for liability rules to provide a sanction for misstatements distorting the market price of securities.

It is against that context that the efficient market hypothesis (EMH) has entered legal orthodoxy over the last three decades.<sup>232</sup> Unfortunately many of the conclusions that have been drawn in relation to the efficient market hypothesis, particularly in the legal sphere, have lacked a proper appreciation of the economic groundings of the theory and of the limitations inherent in certain of the assumptions made by the economists who developed the theory.

The central premise of the efficient market hypothesis is the fairly unremarkable proposition that forces exist in the securities markets that cause information to be rapidly impounded into stock prices. What is more controversial is the view that as a consequence the opportunity for arbitrage opportunities and trading strategies based on fundamental analysis (the analysis of trends, etc) are said not to exist.<sup>233</sup>

In 1970 Eugene Fama proposed the division of the efficient market hypothesis into “weak”, “semi-strong” and “strong” classifications.<sup>234</sup> However, it should be understood that the classification was initially proposed to differentiate the results of empirical tests of price behaviour conducted by economists rather than as alternative models of market efficiency.

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<sup>231</sup> See analysis in Section 3.3.

<sup>232</sup> For a history of the development of the EMH from the mid-1960s in economic literature see S. LeRoy “*Efficient Capital Markets and Martingales*” (1989) 27 J Econ Lit 1583. The first comprehensive economic analysis of the EMH is generally credited to be that contained in *Fama (1970)*.

For an Australian legal perspective see D. Harding “*Implications of the Efficient Market Hypothesis for Securities Regulation*” in Cranston & Shick (eds) “*Law and Economics*” 1982. Australian economists were among the pioneers in the development of the theory - see for example Officer “*The Stock Market: An Introduction to Market Concepts and Australian Evidence*” in Ball et al “*Share Markets and Portfolio Theory*” 1980, University of Queensland Press.

<sup>233</sup> See for example the basic definition in *Gilson & Kraakman (1984)* at 555.

<sup>234</sup> *Fama (1970)* at 383.

Since then, however, the customary approach has been to view that classification as alternative models of how the securities markets deal with particular kinds of information.<sup>235</sup> On this analysis the “weak” form of the efficient market hypothesis postulates the hypothesis that current security prices fully reflect information contained in prior securities prices so that security prices exhibit a “random walk” as each new piece of information is released. The “semi-strong” form of the efficient market hypothesis adds to this proposition by asserting that securities prices fully reflect all publicly available information concerning a security. The “strong” form proceeds on the basis that security prices reflect all information concerning a security, whether publicly disclosed to investors or not.<sup>236</sup>

It is frequently suggested that a choice has to be made between the particular forms of the efficient market hypothesis as best reflecting the operation of the securities markets, most advocates opting for the semi-strong form as the appropriate model.<sup>237</sup> Much of the debate that has gone on in Australia concerning the efficient market hypothesis has been at this fairly mechanical level.

The difficulty with such an assessment of the efficient market hypothesis is that intuitively it must be concluded by any person who has had practical dealings with the Australian securities markets that such a description of the operation of the market is a long way from reality most of the time. Securities prices frequently seem strongly influenced by irrational forces rather than precise and rational reactions to the disclosure of the information that is released concerning particular securities. In addition, in a securities market as thin as Australia’s there seems to be greatly divergent levels of efficiency among different securities at different times, with rumour and speculation frequently having significant impacts on pricing. It is likely that the failure of lawyers and courts to embrace the concept in Australia, among other possible reasons, is an unexpressed suspicion that this mechanical conception of the efficient market hypothesis does not reflect reality.

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<sup>235</sup> See by way of an Australian example in the legal literature *Azzi (1991)* at 208-9.

<sup>236</sup> See *Cunningham (1994)* at 559-562.

<sup>237</sup> For advocates of the semi-strong form of the efficient market hypothesis as an appropriate model for the operation of securities markets in the legal literature see *Banoff (1984)*; *Fox (1984)*; *Rodier (1985)*; *Stout (1988)*. This was particularly seen to be appropriate in the context of liquid markets.

In the Australian context the lack of liquidity of Australian securities markets has been seen to be an issue, but the semi-strong form of the efficient market hypothesis has been argued to be the most appropriate model - see D. Harding *supra* note 224; Pierson, Bird, Brown & Howard “*Business Finance*” 1990, 5th Edition at 530-550 and *Blair & Ramsay (1998)* at 80 (noting that institutional investment in Australian companies is uneven which may reduce information efficiency in relation to companies that are not followed by institutional investors). The same observation has also been made in relation to other relatively small capital markets - see for example *Rodier (1985)* at 26-32 (Canada).

On the other hand, some academic analysis of the efficient market hypothesis offers a more subtle approach to the way in which concepts of market efficiency might be understood. This analysis does not focus on a dogmatic economic categorisation of forms of market efficiency, but instead focuses on likely market responses to the existence of particular kinds of information.<sup>238</sup> Such an approach requires regard to be had, first, to the way the market deals with certain types of information and, secondly, the way in which different types of market participants facilitate market efficiency through their activities.

On this basis an understanding of market efficiency requires regard to be first had to the nature of the information being disseminated to the securities markets. For example, Gilson & Kraakman said that:

“The structure of trading information is holistic and hierarchical rather than additive and democratic. New information may act either as an overlay to an entire range of previously acquired information, or as a fine tuning and confirmation of an existing aspect of trader expectations.”<sup>239</sup>

This point is best illustrated by the distinction between “hard” and “soft” information. For example if an issuer of securities were to announce settlement of litigation resulting in an immediate liability of \$100 million, that “hard” information would be expected to have an immediate and relatively decisive effect on the issuer’s share price. The information would be relatively efficiently impounded into the issuers share price. On the other hand, if the issuer were to announce that litigation had been commenced by a third party seeking damages of \$100 million, accompanied by a statement that the issuer intends to vigorously defend the litigation, the impact of that statement on the share price of the issuer is more difficult for investors to assess. In this situation, there needs to be a recognition that investors will be dealing with uncertainty in making assessments of the likely effects of the information on securities prices. That will involve the application of probability expectations in relation to the information. As such, the views of investors in relation to such an item of disclosure will shift and fluctuate over time in a relatively inefficient manner and security prices will respond accordingly.

Having regard to the way in which information becomes available to the securities market, Gilson & Kraakman have further identified a number of alternative market mechanisms by which that information may become impounded into securities prices. A scheme of classification has

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<sup>238</sup> The most accessible of the “second generation” of the efficient market hypothesis theorists in the legal literature is *Gilson & Kraakman (1984)*.

<sup>239</sup> *Gilson & Kraakman (1984)* at 563.

been proposed that distinguishes four basic methods by which information is absorbed into securities prices:<sup>240</sup>

- “Universally informed trading” - this category of information transmission proceeds on the basis that prices behave as if all investors are costlessly and simultaneously informed of the information in question. Examples of information that might be impounded into security prices in this way would be old information already fully impounded in securities prices (for example last years profit result) or a significant news item that all investors would be immediately aware of (for example an election result or the announcement of a war).
- “Professionally informed trading” - under this category of information transmission valuable information is only available to a minority of knowledgeable investors who control a critical volume of trading activity in the securities in question.<sup>241</sup> An example of information disseminated in this way would be critical information concerning an issuer such as a revision to forecast financial performance disclosed to a small group of investment analysts and institutions at a private briefing where those persons trade the securities in question on a daily basis. In those circumstances it can be expected security prices will rapidly move to reflect the information in question. The influence of market professionals on trading volumes in the market is likely to be the key influence on market efficiency.
- “Derivatively informed trading” - under this category of information transmission information enters the market through a small number of investors whose transactions are not large enough to induce speedy price responses. A classic example would be trading on non-public information by corporate insiders. Efficiency is quickly assisted in such circumstances by “trade decoding” (where uninformed investors observe the transactions of the insider) and by “price decoding” (where uninformed investors observe a change in price caused by the informed trading which suggests to the uninformed investor that there is information supporting the price that insiders are prepared to accept). In these

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<sup>240</sup> *Gilson & Kraakman (1984)* at 565-592.

<sup>241</sup> *Gilson & Kraakman* suggested that more than 70% of trading on the New York Stock Exchange comes from this source - see footnote 69 at 571.

In Australia it is likely the influence of the professional institutional market is even greater for leading stocks that are closely followed by institutional investors.

circumstances the actions of the insiders will move the market through the responses of traders engaged in trade decoding and price decoding activities.

- “Uninformed trading” - the final category of information transmission is completely uninformed trading based on the uninformed beliefs and hunches of investors. For example at a general market level some investors may expect the market to fall while other investors may expect the market to rise, even where there is no basis for that belief. On a security specific level some investors may dislike the management of an issuer while other investors may believe management to be strong, again in circumstances where there is no information that supports or disproves those beliefs. As trading proceeds based on those criteria, the efficient market hypothesis assumes that the random biases of individual traders will ultimately cancel each other out leaving securities prices to reflect a single best informed market assessment of security prices.

Clearly market efficiency and the speed at which market prices reflect relevant information diminishes in the spectrum between universally informed trading (where price adjustment is quickest) to professionally informed trading, to derivatively informed trading and to uninformed trading (where price adjustment is slowest). Gilson & Kraakman argues that further work needs to be done in better illuminating the operation of these market mechanisms.<sup>242</sup>

This analysis of the efficient market hypothesis also includes an important assessment of the role of information costs in determining efficiency. Gilson & Kraakman identify three information costs - the costs of the acquisition of information, the cost of processing information and the cost of verification of information.<sup>243</sup> The lower the cost of information the wider will be its distribution among traders and the more efficient the market will be. On this basis the role of mandatory disclosure rules in the securities markets can be characterised as a “collective signalling device” distributing information to all traders on a cost effective basis.<sup>244</sup>

Importantly for purposes of this dissertation, the imposition of civil and criminal penalties for misstatements in relation to the mandatory disclosure rules can then be perceived as a device to

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<sup>242</sup> Gilson & Kraakman (1984) at 591.

<sup>243</sup> Gilson & Kraakman (1984) at 594.

<sup>244</sup> Gilson & Kraakman (1984) at 601.

reduce verification costs for that information.<sup>245</sup> This is necessary because the integrity of the information impounded into stock prices determines the efficiency of the market.<sup>246</sup>

Recent advances in technology, such as the evolution of the internet during the 1990s, can be viewed as opportunities to reduce information costs because of the opportunity to broaden the range of potential investors who are able to access relevant information at low cost.<sup>247</sup> Further, efficiency may be directly enhanced through the broader range of investors who have direct access to information that previously may have been restricted to market professionals.<sup>248</sup>

When analysed in the above way the efficient market hypothesis can be understood not as a perfect instrument that acts automatically to correct stock prices. Instead the efficient market hypothesis offers a mechanism to explain why markets move to efficiency, the precise speed dependant on each of the variables described above.

This approach also explains why technical analysis remains an important part of the activities of sophisticated securities traders. Clearly above normal gains can be made by reacting sooner than other traders to a piece of information. However that trading leads to the creation of enhanced efficiency through the so called “efficiency paradox”.<sup>249</sup> In addition, a rational investor will seek information until the cost of obtaining the information outweighs the above normal returns that can be achieved from using the information. This conclusion, of course runs counter to the initial thesis that arbitrage opportunities will never exist. However the difference is in the emphasis and on the speed of price correction.

This description of the efficient market hypothesis should be preferred over the more simplistic approach of characterising markets generally as being “weak”, “semi-strong” or “strong”. The challenge for securities regulation is to assess the appropriate regulatory approach to deal with such an understanding of market efficiency. In addition, it should not be assumed that because a market efficiently absorbs information into securities prices (“information efficiency”) that also means market prices reflect a proper fundamental valuation of relevant securities (“market

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<sup>245</sup> *Gilson & Kraakman (1984)* at 605; *Langevoort (1985)* at 769; *Corbett (1999)* at 528.

<sup>246</sup> See J. Floegel “*Equity Financing for Public Corporations: Reasons and Methods to Encourage It*”. *Uni of Penn L Rev* 1411 at 1427.

<sup>247</sup> See *Coffee (1997)* at text accompanying note 11.

<sup>248</sup> See *Langevoort (1985)* at 759.

<sup>249</sup> Identified by S. Grossman & J. Stiglitz “*On the Impossibility of Informationally Efficient Markets*” (1980) 70 *Am Econ Rev* 393. See *Gilson & Kraakman (1984)* at 622-6. The efficiency paradox suggests that gains can be obtained by being the first to correctly interpret information. However, the search to make such gains drives speedy price corrections to ensure market efficiency.

efficiency”).<sup>250</sup> In many cases mandatory disclosure rules will not only be seeking to create information efficiency but also fundamental market efficiency. Of itself, the efficient market hypothesis will not achieve the regulatory goal of market efficiency.

Ultimately, the efficient market hypothesis rests on three basic theoretical underpinnings.<sup>251</sup> First, the proposition that investors are rational and value securities in a rational way. Second, the proposition that to the extent some investors are not rational their trades are random so that they cancel each other out. Third, the proposition that to the extent that a body of investors are irrational, they will be met by other rational investors who will eliminate the influence on prices of irrational investors through arbitrage transactions.

A companion tenet of modern finance theory developed at the same time as the efficient market hypothesis is portfolio theory.<sup>252</sup> Portfolio theory should also be noted as a factor related to principles of market efficiency. The basic thesis of portfolio theory is that the risks associated with individual investments will tend to offset each other. As a consequence an economically rational investor will hold a diversified portfolio of securities to reduce the specific (or systematic) risk associated with individual securities.

From the basic thesis of portfolio theory developed securities selection models such as the capital asset pricing model that seek to measure the risk associated with individual securities.

Portfolio theory has a number of lessons for securities regulation. First, an economically rational investor will hold a large portfolio of securities.<sup>253</sup> Second, an economically rational investor will, in part, select securities on the basis of the volatility associated with the security (the so called “beta” as used in the capital asset pricing model) rather than selecting securities based on more traditional investment criteria. On this basis the mandatory disclosure rules of the securities laws should not only reflect and support the policy underpinnings of information efficiency but should also assist investors in selecting stocks so as to reduce the portfolio risk for that investor.

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<sup>250</sup> See J. Tobin “*On the Efficiency of the Financial System*” (1984) *Lloyds Bank Rev* (July) 1 discussed in *Cunningham (1994)* at 653-4.

This is obviously a consequence of conclusions such as semi-strong efficiency where not all relevant information is reflected in securities prices.

<sup>251</sup> For analysis see *Schleifer (2000)* at 2-5.

<sup>252</sup> Portfolio theory can be traced from H. Markowitz “*Portfolio Selection*” (1952) 7 *J Fin* 77.

<sup>253</sup> See J. Langbein & R. Posner “*The Revolution in Trust Investment Law*” (1976) 62 *ABAJ* 887; *Hu (1990)* at 295-306.

It must be understood that the capital asset pricing model, in particular, suffers many of the ambiguities inherent in any mathematical model that attempts to simplify complex economic issues.<sup>254</sup> At the same as the challenges raised by noise theory described below, a number of studies have been published that challenge the proposition that average returns from securities correlate to systematic risk.<sup>255</sup> However, portfolio theory and finance models such as the capital asset pricing model retain their position as basic tools of modern finance theory.

### The Role of Noise and Influence of Bubbles

In recent years there has been a revisionist rejection of the efficient market hypothesis theory. The so-called “noise” theorists<sup>256</sup> reject the view that efficiency is the normal state of affairs that exist in securities markets. While it is accepted that it is possible for there to be efficiency in the securities markets, it is argued that there will always be significant inefficiencies present which cannot be discounted.

Noise theorists point to events such as the run up of stock prices in 1987 and the subsequent market break on “black Monday” of that year as well as the pricking at the new economy bubble in April 2000 and subsequent “tech wreck” as evidence of the irrational forces that are fundamental features of securities markets.<sup>257</sup> Unlike the efficient market hypothesis, which was developed from economics, the noise theorists draw their experience from the literature of behavioural science.

The essential thesis of the noise theorists is that the premise of rational decisions being the primary driving force of the securities markets and the pricing of securities is open to question. Instead of basing investment decisions on rational action and appropriate information, it is argued that investors tend to trade on “noise”.<sup>258</sup> Investors do not act in a rational “bayesian” fashion to

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<sup>254</sup> Examples of the problems that arise are, first, that a significant number of investors do not diversify their portfolios and, second, market efficiency may not lead to a correct assessment of systemic risk - see Fox (1984) at footnote 30.

<sup>255</sup> See E. Fama & K. French “*The Cross Section of Expected Stock Returns*” (1992) 47 J Fin 427.

<sup>256</sup> The most accessible works includes Langevoort (1992); Cunningham (1994) and Schleifer (2000). See also Schleifer & Summers (1990); R. Shiller “*Market Volatility*” 1989, Princeton University Press and Shiller (2000).

<sup>257</sup> For example J. Stiglitz “*Symposium on Bubbles*” (1990) J. Econ Persp (Spring) 13 but contrast the response of E. Fama to this thesis that if “there are bubbles, economic efficiency is served by letting them burst rather than leak”; E.Fama “*Perspectives on October 1987 or What Did We Learn from the Crash*” in Kamphuis et al (eds) “*Black Monday and the Future of Financial Markets*” 1989 at 77 quoted in Langevoort (1992) at footnote 10.

<sup>258</sup> See F. Black “*Noise*” (1986) 41 J Fin 529.

the disclosure of information where all available data is rigorously analysed and relied upon by individual decision makers, but instead frequently act irrationally.<sup>259</sup>

Examples of such non-bayesian behaviour are said to include the following behavioural traits:

- The tendency of persons to make probabilistic decisions based on the most recent or easily recalled information or information that reflects the latest fad rather than on a more comprehensive set of data.<sup>260</sup>
- The tendency of persons to extrapolate from recently observed trends when there is in fact no sequence in existence.<sup>261</sup>
- The tendency of people to be over-confident in their predictive abilities in dealing with probability, therefore systematically underestimating levels of risk.<sup>262</sup>
- The tendency of people to ignore catastrophic risks which have a low probability of occurring because of an inability to comprehend and evaluate extreme probabilities.<sup>263</sup>
- The tendency of people to overvalue and overemphasise the importance of what they know best (eg their own field of expertise) but underestimate the significance of skills they do not have.<sup>264</sup>
- The tendency to value what is possessed more highly than what is not, explaining why investors sometimes hold securities longer than rational analysis would suggest they should.<sup>265</sup>

<sup>259</sup> Described in *Langevoort (1992)* at 859-61 and at 866-8. Langevoort refers to a number of sources for this analysis including D. Bell et al (eds) *Decision Making: Descriptive, Normative and Prescriptive Interactions* 1988.

<sup>260</sup> *Langevoort (1992)* at 859. See also *Hu (1993)* at 1490 referring to A.B. Atkins & E.A. Dyl "Price Reversals, Bid-Ask Spreads and Market Efficiency" (1990) 25 *J Fin & Quant Analysis* 535; W.F. De Bondt & R. Thaler "Does the Stock Market Overreact?" (1985) 40 *J Fin* 793.

<sup>261</sup> *Langevoort (1992)* at 859.

<sup>262</sup> *Langevoort (1992)* at 859 referring to W. Edwards & D. Winterfeldt "Cognitive Illusions and Their Implications for the Law" (1986) 59 *S Cal L Rev* 225.

<sup>263</sup> *Hu (1993)* at 1488 referring to J.M. Guttentag & R.J. Herring "Disaster Myopic in International Banking" in "Essays in International Finance" 1986, Princeton University.

<sup>264</sup> *Hu (1993)* at 1490-1 referring to R. Zechhauser "Nonrational Actors and Financial Market Behaviour" (1991) 31 *Theory & Decision* 257.

<sup>265</sup> *Langevoort (1992)* at 860 referring to H. Shefrin & M. Statman "The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence" (1985) 40 *J. Fin* 777.

- The possibility that a large number of people invest not simply to make money but to “play” the market, with the result that the biases of gamblers are exhibited.<sup>266</sup>

Each of the above phenomena are said to illustrate behavioural strategies employed by individuals in a world where there is too much information and too many choices.<sup>267</sup> The effect of this irrational non-bayesian behaviour is that individuals rely on cognitive shortcuts (such as the above heuristics and biases) to solve complex issues. The cognitive shortcuts are likely to be irrational and mistaken.<sup>268</sup>

Based on this type of analysis, commentators such as Shiller<sup>269</sup> have argued that the bulk of investors do not have the capacity to make investment decisions independently and instead rely principally on peer opinion as a primary basis of decision making. The result of peer decision making is that there is a group dynamic to the investment decision that is significantly influenced by rumours and fads rather than economically rational decision making. People do not deviate from rationality randomly but instead deviate in the same way, so that “investor sentiment” reflects the common judgment errors made by a substantial number of investors and not uncorrelated random mistakes.<sup>270</sup> In extreme situations these common biases cause “bubbles” through the effect of positive feedback strategies that influence the sentiment of investors generally. The new economy boom ending in April 2000 was seen by Shiller to be fundamentally affected by those factors.<sup>271</sup>

It is important to appreciate that these characteristics of decision making are not just relevant to unsophisticated investors (or the so-called “uninformed trading” aspect of information efficiency described above) but to all investors, and all trading, no matter how sophisticated. For example, it has been argued that cognitive biases have a profound impact on the derivatives markets that are the preserve of only sophisticated financial intermediaries.<sup>272</sup> Professional funds managers may also effectively reflect irrational decision making by holding portfolios that reflect market

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<sup>266</sup> *Langevoort (1992)* at 868.

<sup>267</sup> *Langevoort (1992)* at 860 referring to H. Simon “A Behavioural Model of Rational Choice” (1955) 69 QJ Econ 99 and the view expressed that in the face of uncertainty individuals do not search for the optimal solution but instead for the best they can given the costs associated with gathering and processing information.

<sup>268</sup> *Hu (1993)* at 1488; R. Noll & J. Krier “Some Implications of Cognitive Psychology for Risk Regulation” (1990) 19 J Legal Stud 747.

<sup>269</sup> *Shiller (1990)* at 61-2. Also see summary in *Langevoort (1992)* at 867-8.

<sup>270</sup> *Schleifer (2000)* at 12.

<sup>271</sup> *Shiller (2000)* at Chapter 2.

<sup>272</sup> See *Hu (1993)* at 1487-1491.

indexes<sup>273</sup> or by copying the decision making of other funds managers, so that their performance is consistent with their peers, rather than risking a poorer performance on a peer comparison basis.<sup>274</sup> Indeed some successful investors attribute their success not to fundamental securities analysis but to betting on future crowd behaviour.<sup>275</sup>

It is argued that the proposition that such irrational behaviour will be corrected through rational arbitrage activity fails to have regard to the finite risk bearing capacity of arbitrageurs as a group,<sup>276</sup> particularly when confronted with the force of a market where bubble behaviour exists.<sup>277</sup> The existence of bubble markets is well documented and it is argued that their essential characteristics are remarkably similar when compared with the background circumstances that precipitated the existence of the bubble.<sup>278</sup>

The fundamental theoretical difference between noise theory and the efficient market hypothesis can therefore be identified. The key issue is what is the natural state or paradigm that drives the market - the efficient impounding of all available information, as the economists would have it under the efficient market hypothesis, or sub-optimal decision making, as the behavioural scientists would have it under noise theory. As noted in relation to the discussion of the efficient market hypothesis above, uninformed trading may be a significant feature of the operation of the securities markets but it is asserted by the economists that the random biases of individual traders will cancel each other resulting in an efficient market. However if the basic paradigm is instead sub optimal decision making processes that conclusion is open to doubt.<sup>279</sup> The theoretical

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<sup>273</sup> For example holding stocks so that the portfolio tracks the ASX index - See *Schleifer (2000)* at 12.

<sup>274</sup> See J. Lakonishok, A. Schleifer & R. Vishny "*The Structure and Performance of the Money Management Industry*" cited in *Schleifer (2000)* at 12-13.

<sup>275</sup> See G. Soros "*The Crisis of Global Capitalism*" 1998, New York Public Affairs discussed in *Schleifer (2000)* at 156-7.

See also the classic analogy drawn by J. M. Keynes in the "*General Theory of Employment, Interest and Money*" between professional investment and a beauty contest where the objective is not to pick the six prettiest faces but instead to pick what the average person would pick as the six prettiest faces.

<sup>276</sup> See *Schleifer (2000)* at 14. The most notable example of the failure of arbitrageurs to deal with arguable irrational market conditions was the collapse of Long Term Capital Management in 1998 - see the description in *Schleifer (2000)* at 107-111.

<sup>277</sup> See *Shiller (2000)* at Chapter 3. Bubbles are said to develop through simplification mechanisms where cycles of increasing sentiment are heightened through "a sort of feedback loop" or "naturally occurring Ponzi process".

<sup>278</sup> Bubbles in a variety of contexts are described in C. Mackay "*Extraordinary Popular Delusions and the Madness of Crowds*" 1841, Templeton Foundation Press, printed 1999; W. Bagehot "*Lombard Street*" 1872, Smith Elder and C. Kindleberger "*Manias, Panics and Crashes*" 1978, Basic Books. See also the description of bubbles in *Schleifer (2000)* at 169-174.

<sup>279</sup> See *Langevoort (1992)* at 862, *Schleifer & Summers (1990)* at 23 and *Schleifer (2000)* at 10-16.

foundations of noise are the forces of investor sentiment and limited arbitrage opportunities to correct inefficiencies.<sup>280</sup>

One way of explaining the impact of noise is the potential application of “chaos” theory, a theory that seeks to explain apparently random events that became fashionable in many academic areas in the 1990s.<sup>281</sup> Under such a model the impact of disclosure would be explained through non-linear impacts on securities prices, rather than the linear impacts suggested by the efficient market hypothesis.<sup>282</sup> Noise theory would explain the forces that drive securities markets while chaos theory would provide the structural explanation for those effects.<sup>283</sup> However the development of a compelling theoretical basis for that approach is very much in its infancy.

In the legal context it must be understood that the proof, or otherwise, of the validity of each of the efficient market hypothesis and the views of the noise theorists will rest on the validity of the empirical research undertaken in the finance field.<sup>284</sup> In the interim it can be argued the prudent legal policy maker should remain somewhat of a sceptic of the absolutes of either theory. However, despite the uncertainty, it has been suggested that the efficient market hypothesis:

“remains a useful heuristic, analytical structure for thinking about markets”<sup>285</sup>

In particular, it remains a fundamental tenet of securities regulation that the availability to price makers of reliable information is essential to the markets ability to align stock prices with its fundamental value.<sup>286</sup>

As such, what conclusions should be drawn for purposes of assessing the liability regime for prospectus misstatement contained in the *Corporations Act*? First, is the (unremarkable) proposition that securities prices do in some fashion impound information disclosed by issuers.

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<sup>280</sup> See *Schleifer (2000)* at 24-6.

<sup>281</sup> For analysis see *Cunningham (1994)*, particularly at 571-607.

<sup>282</sup> See *Cunningham (1994)* at 572. A non-linear impact suggests the effect of disclosure may lack proportionality. Therefore for example, the disclosure of information results in price impacts in a way that is not proportional to what a rational person would expect.

<sup>283</sup> An example given in *Cunningham (1994)* at 592-4 would be an explanation of why stock market cycles have tended to have a length of 4 years over recent decades so that market crashes could be modelled.

<sup>284</sup> See *Langevoort (1992)* at 869-871 and an overview of the competing empirical evidence in *Schleifer (2000)* at 5-10 and 16-23. Schleifer suggests it will take a lot of data and perhaps a better theoretical idea of what to look for before researchers can find persuasive evidence (*Schleifer (2000)* at 23).

<sup>285</sup> *Langevoort (1992)* at 913. For continuing support of the theory see Lee & Verbrugge “*The Efficient Market Theory Thrives on Criticism*” (1996) 9 J App Corp Fin 35.

<sup>286</sup> See M. Kahan “*Securities Laws and the Social Costs of ‘Inaccurate’ Stock Prices*” (1992) 41 Duke LJ 977 at 988-9.

Second, is the view that a thoughtful analysis of the literature of the efficient market hypothesis can assist in explaining those processes with lessons as to the ways in which the securities laws might facilitate that process or be calibrated so as to facilitate efficiency in a cost effective fashion. Liability rules can be seen as an important cost effective verification device in that regard. Finally, the absolutes of efficiency should be questioned and the behavioural literature on decision making under uncertainty as well as developments in chaos theory should be seen as a substantial influence on the legislative and regulatory approach that is adopted in understanding the operation of the capital markets.<sup>287</sup> In particular, special techniques to address irrationality may need to be employed where a bubble exists (if the existence of the bubble can be identified). As such, mandatory disclosure rules may need to be seen as a tool that is employed to assist the operation of markets.<sup>288</sup>

### **To What Investor Should a Prospectus be Addressed?**

A somewhat subsidiary issue that arises from a discussion of the way in which securities markets impound prices is the question of how individual investors deal with information that is disclosed to them. Clearly that debate is substantially influenced by the lessons of the general theories of the efficient market hypothesis and noise theory discussed above. Those theories deal at the “macro” level of the operation of securities markets. A different way of assessing the appropriate policy response is to approach the issue at a “micro” level and ask how individual investors (particularly retail investors) in fact respond to the information that is disclosed to them through the current mandatory disclosure rules. That analysis has lessons as to how information should be delivered to different types of investors through the mandatory disclosure rules.

The orthodox approach of the review bodies that developed the prospectus disclosure laws outlined in Section 1.4 and Section 1.5 was to assume that all investors do in fact act in a uniform way to the information that is disclosed to them. As a consequence, the premise of the securities laws has been that disclosures in a prospectus should be relevant and comprehensible to the unsophisticated investor as well as to the institutional investor who has sophisticated analyst resources.

Clearly, over the last two centuries much has changed in the manner in which investment decisions are made. When the first modern companies legislation was introduced in England in

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<sup>287</sup> *Langevoort (1992)* at 914.

<sup>288</sup> See *Cunningham (1994)* at 604.

the 1840s it would have been the case that the securities markets were dominated by individuals (often wealthy and well educated) who made their own investment decisions. Today, the position is much more complex.<sup>289</sup>

Four broad stages of intermediation of the investment process have been identified.<sup>290</sup>

- The entrepreneurial period that gave rise to the modern corporate form in the nineteenth century.
- The development of the professional business manager, giving rise to the split between ownership and control from the early to mid twentieth century.<sup>291</sup>
- The rise of the portfolio manager, reflecting the primacy of institutional investors and financial intermediaries in the securities markets in the third quarter of the twentieth century.<sup>292</sup>
- The rise of savings planners in institutionalising savings and employee incentive arrangements in the late twentieth century.

It is suggested that these developments have led to greater concentration of important discretionary powers concerning the capital mobilising process in the hands of professional managers.<sup>293</sup> It is necessary for regulation to be responsive to these developments and to deal with the issues that arise from the changing role and significance of the different participants in the securities markets.<sup>294</sup>

It can be argued that reform analysis over the last decades have failed to have sufficient regard to these changing circumstances.<sup>295</sup> There has been strong criticism of the orthodox view that

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<sup>289</sup> For analysis of developing perceptions of the analytical approach underlying corporate law generally see the analysis in D. Millen "Theories of the Corporation" [1990] Duke L.J. 201.

<sup>290</sup> Clark (1981) at 561-572.

<sup>291</sup> The seminal work being A. Berle & G. Means "The Modern Corporation and Private Property" 1933.

<sup>292</sup> See R.C. Clark "The Regulation of Financial Holding Companies" (1979) Harv L Rev 782; H.E. Bines "Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine" (1976) Columbia L Rev 721.

<sup>293</sup> Clark (1981) at 568.

<sup>294</sup> Among other things, this has resulted in the development of the nexus of contracts theory of corporations where corporate law is seen as a nexus of contractual negotiation between the affected parties - see W.W. Bratton "The 'Nexus of Contracts' Corporation: A Critical Appraisal" (1989) 74 Cornell L Rev 407.

<sup>295</sup> For example in the United States, in a major review of the thrust of the securities laws in the late 1960s, the Wheat Report ("Disclosure to Investors: A Reappraisal of Federal Administrative Policies Under the '33 and '34 Acts" 1969, Securities and Exchange Commission) persevered with the view that the securities laws had to remain relevant and addressed to all investors.

investors should be treated homogeneously for the purpose of framing the securities laws. A key critic since the late 1960s was Professor Homer Kripke.<sup>296</sup> He challenged the view that an intelligent, non-professional investor could make informed decisions based on modern prospectuses and suggested that such an expectation is a delusion.<sup>297</sup> Reasons for this view include that the complexity of modern accounting rules make it impossible for an untrained investor to base proper investment decisions on such accounts.<sup>298</sup>

Kripke argues that the key to rationale investment decision making under modern disclosure documents should rest with financial analysts and portfolio managers.<sup>299</sup> The goal of disclosure should be to ensure that professionals have sufficient information to make informed decisions so that the security's price properly impounds all available information. In doing so it must be recognised that the unsophisticated investor will be unable to deal in any meaningful way with the detail of those disclosures. However the unsophisticated investor will be able to "free ride" on the work undertaken by the market professionals because the views of market professionals will be reflected in the price of the securities.<sup>300</sup>

It is therefore suggested that there is an inherent conflict between "full" disclosure as required by the professional investors and "fair" disclosure which presents a comprehensible description of the investment for the average investor.<sup>301</sup> If that is correct most modern critics would opt for the view that "full" disclosure should be preferred over "fair" disclosure so as to enhance market efficiency.

This analysis is also supported by evidence that investors, particularly retail investors, do not read modern prospectuses. In the 1990s there has been anecdotal evidence to support the view that, particularly in boom conditions, investment decisions are made by retail investors without review of the prospectus document.<sup>302</sup> This is also borne out by commentary in other jurisdictions.<sup>303</sup>

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<sup>296</sup> The most comprehensive description of Kripke's thesis is contained in *Kripke (1979)*.

<sup>297</sup> The analysis of Kripke draws heavily on the work of the efficient market hypothesis and portfolio theory discussed above. The assumption that unsophisticated investors will not be harmed by free riding on the market price in buying securities assumes an efficient market - see *Kripke (1970)* at 1169.

<sup>298</sup> See Chapter 23 of *Kripke (1979)*.

<sup>299</sup> *Kripke (1970)* at 1169; *Kripke (1973)* at 633.

<sup>300</sup> *Kripke (1973)* at 637.

<sup>301</sup> See *Anderson (1974)* at 351 - 3.

<sup>302</sup> For example in Note (J. McKay) "Promoting a Fairer Application of *L'Estrange v Graucob* in the Disclosure Regime of the Corporations Law" (1993) 11 C&SLJ 259 it is asserted that in the two first large privatisation offerings undertaken in Australia in the

On the other hand, research commissioned by ASIC in the mid-1990s suggest the true position may not be so straightforward.<sup>304</sup> The methodology of the survey conducted by Chant Link seems strong - involving a comprehensive survey of the views of a number of retail investors and advisers in relation to a range of offerings.<sup>305</sup>

A number of valuable insights were obtained. First, perhaps surprisingly, most of the retail investors claimed they did read the prospectuses in detail, with 70% of the investors claiming to have read the prospectus in some detail and only 6% claiming not to have read the document at all.<sup>306</sup> This casts some doubt on the anecdotal view that retail investors only read the chairman's letter of an Australian prospectus and undertake a cursory review of the disclosures before making an investment decision.<sup>307</sup> The survey suggests that the response of retail investors should be preferred over the intuition of market professionals (indeed the cynical might suggest that market professionals have a degree of self interest in suggesting retail investors do not read prospectuses so as to advance perceptions of their own importance in the investment process). The issue is whether these responses correctly reflect retail investor practice or whether, possibly, the response has been exaggerated by the survey methodology.<sup>308</sup>

The survey therefore suggests that modern retail investors see a role for prospectuses and see it is an important source of information to them.

Second, the research reinforced the existence of interaction between the prospectus and the role performed by advisors and brokers in forming investment decisions.<sup>309</sup> 80% of retail investors said they relied on brokers/advisors as a source of information, with 55% stating that

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early 1990s (Commonwealth Bank of Australia and GIO) there was little evidence of investors reading prospectuses. A sample of investors selected by the author in the first of those offerings revealed 50% of applications were made on the first day the prospectus was available (shares were allocated based on the date of application) - at 260.

The survey in question would not appear to have been particularly detailed and the analysis seemed something conclusory.

<sup>303</sup> See of example *Langevoort (1992)* at 880-1; *Rodier (1985)*.

<sup>304</sup> Chant Link & Associates "A Market Research Report for the Australian Securities Commission On Prospectuses Amongst Retail Investors and Their Advisers" Public Exposure Document Project Number 680 (31 March 1994) ("*Chant Link survey*").

<sup>305</sup> The survey involved 304 retail investors from a variety of backgrounds (traders, experienced long term investors and new investors) and 41 brokers and advisers to gain comments on 4 initial public offerings by corporate issuers and 2 trust managed fund offerings (*Chant Link survey* at 15). The approach adopted for the survey suggests methodological rigour - *Chant Link survey* at 12.

<sup>306</sup> *Chant Link survey* at 37. 48% of the retail investors claimed to have read the whole prospectus.

<sup>307</sup> The survey itself noted that advisers felt there was much lower readership of prospectuses than the investor research indicated was actually the case - *Chant Link survey* at 97-8. Indeed, the chairmans letter was seen by most retail investors as unimportant and an area where puffery or meaningless generalisations were often found - *Chant Link survey* at 55.

<sup>308</sup> For example, by concerns of perceived foolishness if they had said they did not read the prospectus.

<sup>309</sup> *Chant Link survey* at 29.

brokers/advisors were their primary source of information. Next most influential was the statutory prospectus with 73% of responses identifying it as a source of information, but with only 5% as the primary source of information.<sup>310</sup> This research clearly flags the intermediation of the investment decision making process and also points to the role of various types of investors in facilitating market efficiency as outlined above.<sup>311</sup>

Finally, the survey is interesting in its identification by both retail investors and advisors of perceived deficiencies with prospectus. Both groups saw deficiencies in the prospectuses surveyed and other prospectuses they had seen. However, critically, the majority of retail investors felt that prospectuses were a necessary and very important source of information for making investment decisions.<sup>312</sup> The key improvements that could be made to prospectuses mentioned by retail investors were:<sup>313</sup>

	%
Plain English, less jargon	30
Shorter, simpler, less repetitious	28
Better summary	12
More information	12
Less glossy	10

On the other hand advisors saw that the key improvements required were to reduce the length and legalism of prospectuses so as to provide critical data, details of how to participate in the offering and the nature of the investment.<sup>314</sup> Standardised disclosure was considered desirable.

Much of these comments can be seen to be striving for an outcome for that user that will be difficult to achieve in practice where a complicated investment decision needs to be made - retail investors want a simple but comprehensive disclosure while advisors want key information to allow comparisons between investments. The survey results endorsed the view from both retail

<sup>310</sup> Other sources are instructive: newspapers 55% (10% primary source - *ie* more influential than the prospectus); broker research 48% (5% primary source); magazines 36% and radio 25% (only marginally ranked as primary sources) and friends and relatives 21% (5% primary source).

<sup>311</sup> Of relevance were responses to the reasons for reading a prospectus where the main responses were to decide whether or not to buy 72% (main reason 30%); to respond to the brokers/advisors recommendation 53% (main reason 25%); to decide whether it is the right investment 55% (main reason 15%); to decide how many securities to buy 40% (main reason 5%) - *Chant Link survey* at 43.

<sup>312</sup> *Chant Link survey* at 35-6 and 48-9.

<sup>313</sup> *Chant Link survey* at 71.

<sup>314</sup> *Chant Link survey* at 132.

investors and from advisors that different types of disclosure documents may be appropriate so that two sizes of disclosure document, abbreviated and detailed, meet the needs or desires of different investors.<sup>315</sup>

It should be noted that the Chant Link survey came at an early point following the enactment of the *Corporations Law* and covers only a limited number of prospectuses at a time of relative upturn in equity markets. It would be interesting to contrast the results of such a survey over a longer period and over differing market conditions, following a longer period of adoption of the approach to prospectus regulation reflected by the *Corporations Act*.<sup>316</sup>

It is submitted that this type of analysis is the type of inquiry that would significantly advance the debate as to the mandatory disclosure rules.<sup>317</sup> While the debate as to the lessons of the efficient market hypothesis and noise theory leads to uncertainty as to the appropriate policy underpinnings for mandatory disclosure rules, the lessons that arise from research into the basic information needs of different types of investor groups in modern markets where intermediation exists offer more modest but clearer outcomes. Clearly the cost of the mandatory disclosure rules would be reduced through an approach that more directly addresses the disparate needs of different types of investors, it being recognised that such an approach should not deny the market access to all information provided to all categories of investor groups. Unfortunately the detail of this survey did not seem to have been seized upon to any significant degree in formulating the *CLERP Act* revisions (see analysis below and in Section 6.1).

### **The Unresolved Debate on the Philosophy of Regulation - Information Economists and their Critics**

Finally, by way of general survey of the theoretical policy underpinnings for mandatory disclosure rules, over the last two decades in the United States there has been a vigorous debate on the underlying philosophical approach to mandatory versus market induced disclosure of information which should be factored into the debate on the structure of the disclosure and liability regime in Part 6D.3 of the *Corporations Law*.

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<sup>315</sup> *Chant Link survey* at 77.

<sup>316</sup> An interesting comment made by *Kripke (1979)* in the United States is that if the regulator really wanted to understand what information investors demand and expect to find under a mandatory disclosure regime, it could do no better than study the private placement market (at 121).

<sup>317</sup> Such analysis is rarely seen in the literature. One (fairly basic) analysis is seen in *Rodier (1985)* in Canada (concluding that few average investors understand the contents of the simplest of prospectuses) at 37-42.

For purposes of this dissertation the debate will be labelled as the debate surrounding the “information economists”. The information economists argue that the securities market itself is capable of ensuring that adequate information is available to investors and that it is undesirable to have regulatory intervention to require the mandatory disclosure of information.

It would seem that the debate has as much to do with politics as it does with economics, being spawned in its current form in the United States during the Reagan-era. It would also seem that the debate has an air of unreality about it. If there is one lesson that can be learned from the historical overview of the development of the securities laws, as summarised in Section 1.4, it is that self-regulation of fundraising had not appeared to act as a satisfactory regulatory response in the English and United States securities markets in the eyes of investors and politicians, at least from the mid-nineteenth century to the first quarter of the twentieth century.

The current debate was initiated by Professor Stigler in 1964 with his assertion that empirical evidence suggested United States investors had not benefited from the adoption of mandatory disclosure requirements in the *Securities Act* in 1933.<sup>318</sup> His thesis was that the securities laws introduced in the United States in 1933 and 1934 did not have any beneficial effect on investment decisions but instead had merely led to unnecessary costs in the capital raising process. Not unsurprisingly this view was strongly challenged on the basis of the methodology used, the statistical results and the inferences drawn.<sup>319</sup>

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<sup>318</sup> Stigler “*Public Regulation of the Securities Markets*” (1964) 37 J Bus 117 (extracted in Chapter 11 of *Posner & Scott (1980)*). The study was based on an analysis of price ratios of industrial stock IPO’s in 1923-28 compared with 1949-55 in the 5 years following each IPO. The average return on stocks in each sample were argued to show no statistical difference.

<sup>319</sup> See Friend & Herman “*The SEC Through a Glass Darkly*” (1964) 37 J Bus 382 (extracted in Chapter 11 of *Posner & Scott (1980)*). The debate continued - Stigler “*Comment*” (1964) 37 J Bus 414; Friend & Herman “*Professor Stigler on Securities Regulation: A Further Comment*” (1965) 38 J Bus 106 (both extracted in Chapter 11 of *Posner & Scott (1980)*). See also Benston “*The Value of the SEC’s Accounting Disclosure Requirements*” (1969) 44 Acct Rev 515.

The debate was again activated by Benston in 1973 who sought to support Stigler by arguing through statistical analysis that mandatory disclosure under the 1934 Act was of no value to investors. Benston “*Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*” (1973) 63 Am Econ Rev 132 (extracted in chapter 11 of *Posner & Scott (1980)*).

Stigler’s views also found the support of Professor Manne - Manne “*Economic Aspects of Required Disclosure under Federal Securities Laws*” in “*Wall Street in Transition: The Emerging System and its Impact on the Economy*” 1974, NYU. The conclusion of the statistical analysis was that mandatory disclosure requirements of the 1934 *Securities Exchange Act* had no measurable positive effect on securities traded and, as such, there appears to be little basis for securities legislation and no evidence that it was needed or desirable. Again Friend rose to the defence of the securities laws challenging the methodology and the conclusions drawn by Benston. Friend & Westerfield “*Required Disclosure and the Stock Market*” (1975) 65 Am Econ Rev 467 (extracted in Chapter 11 of *Posner & Scott (1980)*). The debate dragged on - Benston “*Required Disclosure and the Stock Market: Rejoinder*” (1975) 65 Am Econ Rev 473 (extracted in Chapter 11 of *Posner & Scott (1980)*).

For a summary of the overall debate see J. Seligman “*The Historical Need for a Mandatory Corporate Disclosure System*” (1983) 9 J Corp L 1.

From the realm of empirical analysis, these arguments were taken up in the 1980s by the information economists who have preferred to argue the issue from a theoretical policy perspective.<sup>320</sup>

The essential thesis of the information economists is that the securities laws are a classic illustration of “public interest” legislation that overlooks how markets themselves operate to protect the interests of investors.<sup>321</sup> The concern is that the structure of United States securities laws give larger issuers an advantage over smaller issuers as many of the costs of disclosure are the same regardless of the size of the offering. The rules also benefit the parties with vested interests in the retention of a costly structure - lawyers, accountants and investment banks.<sup>322</sup>

Easterbrook & Fischel argue that:

“If disclosure is worthwhile to investors, the firm can profit by providing it. The firm is in privity with its investors, and they should be able to strike a mutually beneficial bargain. A decision by the firm effectively “co-ordinates” the acts of many investors who would not bargain directly. As we have emphasised from the beginning, managers who omit cost justified steps for the protection of investors will receive less money for the securities the firm issues; the entrepreneurs and managers, not the investors, pay the price ... the process works for bad news as well as good. Once a firm starts disclosing it cannot stop short of making any critical revelation, because investors assume the worst. It must disclose the bad with the good, else investors will assume that the bad is even worse than it is ... firms have been disclosing important facts about themselves - and certifying those facts through third parties - as long as there have been firms. It is possible to trace a use of auditors back to the beginning of the corporation.”<sup>323</sup>

As such, it is argued that the “invisible hand” of the securities market ensures that investors are provided with the appropriate information necessary for investment decisions.<sup>324</sup> In particular, it has been argued that the disclosure incentive will be strongest in the case of the new issue market

<sup>320</sup> The strongest advocates against a mandatory disclosure regime are Easterbrook and Fischel - see *Easterbrook & Fischel (1984)* and chapter 11 “Mandatory Disclosure” in *Easterbrook & Fischel (1991)* (in this chapter referred to as “Mandatory Disclosure”).

The strongest advocate of the contrary view in favour of legislating to require mandatory disclosure is Professor J.C. Coffee - see *Coffee (1984)*.

In the Australian context the debate is well summarised in *Blair & Ramsay (1998)* and *Blair (1992)*.

<sup>321</sup> *Easterbrook & Fischel (1984)* at 672-3.

<sup>322</sup> *Easterbrook & Fischel (1984)* at 671-2; *Mandatory Disclosure* at 278-9. Easterbrook & Fischel are however sceptical of attempts to sheet home the benefit argument as a main reason for the way in which the securities laws have developed because there are too many interested parties to permit monopoly pricing - see *Mandatory Disclosure* at 279 and the articles cited at footnote 7 there.

<sup>323</sup> “Mandatory Disclosure” at 288-9. See also J. Macey “Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at 60” (1994) 15 *Cardozo L Rev* 909 at 928 and R. Romano “Empowering Investors: A Market Approach to Securities Regulation” (1998) 107 *Yale LJ* 2359 at 2367-8.

<sup>324</sup> In the Australian context it has been suggested that in New South Wales there was extensive voluntary disclosure in the Nineteenth century despite the absence of mandatory disclosure requirements - see Morris “Corporate Disclosure in a Substantially Unregulated Environment” (1984) 20 *Abacus* 52 cited in *Blair & Ramsay (1998)* at footnote 8.

because of the power investors hold over issuers in this situation.<sup>325</sup> Not only is the possible alternative to disclosure in this situation the possibility the offering will fail but there is also competition among issuers for investor funding as well as the possibility of reducing the cost of capital through making fuller disclosure to assist the decision making of investors.<sup>326</sup>

The information economists and their critics canvass a number of reasons that might support the necessity for mandatory disclosure rules and the validity of those reasons. Each of these arguments are put on the basis that mandatory disclosure is necessary to overcome a market failure to produce necessary information that would arise if disclosure was voluntary.<sup>327</sup>

First the argument is frequently put that mandatory disclosure increases public confidence in the securities markets because mandatory disclosure rules deter fraud and equalise access to information.<sup>328</sup> Easterbrook & Fischel argue that there is no evidence that disclosure rules, as distinct from appropriate sanctions for fraud, have this effect.<sup>329</sup> It is asserted by the information economists that the argument of public confidence is unproven by any scientifically acceptable evidence and that the costs of securities regulation are outweighed by any benefit of public confidence. On the hand, the incentive not to disclose is said by the critics of the information economists to be strongest in relation to matters where management has self interest.<sup>330</sup> The information economists reject this concern for the reasons advanced above.

The second argument frequently put is that unsophisticated investors need the protection of mandatory disclosure rules to have equal access to information and to be entitled to the presentation of information in a way that all investors can understand.<sup>331</sup> Easterbrook & Fischel assert that this fails to have regard to the role of modern securities markets in impounding

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<sup>325</sup> See *Kripke (1979)* at 119.

<sup>326</sup> *Kripke (1979)* at 121-3.

<sup>327</sup> See *Blair & Ramsay (1998)* at 62-3; J. Seligman "The Historical Need For a Mandatory Corporate Disclosure System" (1983) 9 J Corp L 1.

<sup>328</sup> In the Australian context a public confidence argument was put as a fundamental basis for Australia's disclosure laws in the 1981 Campbell Committee report - "Australian Financial System - Final Report of The Committee of Inquiry" (1981, AGPS).

<sup>329</sup> *Easterbrook & Fischel (1984)* at 692-3; "Mandatory Disclosure" at 296-7. Reference is made by Easterbrook & Fischel to the innumerable frauds that have been uncovered since the introduction in the United States securities laws and the failure of those frauds to undermine confidence in the securities markets, as was also the case prior to the implementation of the United States securities laws.

<sup>330</sup> See *Coffee (1984)* at 737-747; *Blair & Ramsay (1998)* at 69-74.

The examples are executive compensation, management trading in securities and "going-private" transactions where management seek to acquire control of the issuer.

<sup>331</sup> *Easterbrook & Fischel (1984)* at 693-5; "Mandatory Disclosure" at 297-8.

information in securities prices.<sup>332</sup> Unsophisticated traders can take a “free ride” on the information impounded in the market price. In any event, it is argued that sanctions for fraud should more than adequately protect the uninformed from being preyed upon by unscrupulous issuers. The discussion outlined above would suggest that this assertion has merit.

The third argument frequently put is the view that mandatory disclosure rules are necessary to ensure sophisticated investors are provided with the information they need to make decisions in order to ensure the efficiency of the securities markets.<sup>333</sup> The information economists respond by suggesting that more information is not necessarily better than less and that sophisticated investors have an appropriate bargaining position to ensure that their information needs are met. Easterbrook & Fischel refer to the historical criticism of the US securities laws in failing to ensure that forward looking information is provided in prospectuses as evidence that a non-market driven system of disclosure does not necessarily ensure that appropriate information is delivered to investors.<sup>334</sup>

Additional reasons have been given by the critics of the information economists as to the need for mandatory disclosure rules. The first of these is based on the economic theory of externalities and the concept of public goods.<sup>335</sup> A public good is said to be a good or service (exemplified by a park or national defence service) where there is little incentive for private individuals voluntarily to provide the good or service because one person’s use of the good does not reduce its availability to other persons (in other words once produced it is available to everyone) and the person producing the good cannot exclude other persons from using the good (free riders cannot be excluded).

It is argued that information in relation to securities has such a public good characteristic.<sup>336</sup> On this basis it is argued that, in the absence of mandatory disclosure, firms have no incentive to disclose information because they will not be adequately compensated for that disclosure. On the other side, securities analysts would be unwilling to undertake the work to disclose relevant

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<sup>332</sup> On this basis it can be suggested that it is more efficient for certain investors to remain uninformed than to attempt to access relevant information - see *Blair & Ramsay (1998)* at 68.

<sup>333</sup> *Easterbrook & Fischel (1984)* at 695-6; “*Mandatory Disclosure*” at 298-300; *Rodier (1985)* at 37.

<sup>334</sup> See Section 6.3 analysis below.

<sup>335</sup> The primary advocate in the 1980s was Professor Coffee - see *Coffee (1984)*.

<sup>336</sup> See Mendelson “*Economics and the Assessment of Disclosure Requirements*” (1978) 1 *J Comp Corp Law & Sec Reg* 49; *Coffee (1984)* at 723-737.

information because it is not possible to exclude the use of the information by others and because of the risk of free riders then using the information.

The highly theoretical nature of the public goods debate has been criticised for its failure to address real world circumstances.<sup>337</sup>

The foregoing is not to suggest that the information economists do not believe there are any grounds to support a mandatory disclosure system. The primary reason given for sanctioning mandatory disclosure is said by Easterbrook & Fischel to be the control of “third party effects”. A concern with self induced disclosure identified by Easterbrook & Fischel is that disclosures made by one issuer may be of use to its competitors. Because there is no benefit to an issuer providing information that may be of use to its rivals, that type of information will be under-produced and each competitor in the market will want to avoid disclosure of this type of information.<sup>338</sup> It is therefore argued that only by compelling all competitors to produce information will any particular issuer feel comfortable in doing so.

A further reason given by the information economists for requiring mandatory disclosure is based on the costs associated with the operation of the judicial system as it applies to the enforcement of remedies for fraud. Enforcement proceedings involve considerable risk for all parties as it is only long after the event that liability or innocence will be determined. In addition litigation is an expensive mechanism to ensure that issuers engage in appropriate conduct. It is therefore argued that the costs associated with a mandatory disclosure regime should be compared to the costs associated with a regime based solely on sanctions so that an appropriate balance is reached.<sup>339</sup> In other words, the concern requires that the cost associated with the “enforcement effect” of disclosure be compared to the costs and benefits of the “information effect” of disclosure as outlined at the commencement of this section.

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<sup>337</sup> See *Blair & Ramsay (1998)* at 75-6. It is also noted that in practice most goods have both public and private characteristics. See *Herder (1995)* at 187.

*Kripke (1979)* at 118 commented on the public good argument as applied to voluntary disclosure by firms in the following terms:

“The whole academic argument is irrelevant because it deals with information unilaterally produced in some kind of empty state of world.”

The Coffee view of underproduction of information by securities analysts does not fully explain why securities analysts cannot profit from their own use of information produced - see *Blair & Ramsay (1998)* at 76.

<sup>338</sup> *Easterbrook & Fischel (1984)* at 697; “*Mandatory Disclosure*” at 300.

<sup>339</sup> *Easterbrook & Fischel (1984)* at 699; “*Mandatory Disclosure*” at 302. Easterbrook & Fischel further suggest another reason to endorse mandatory disclosure is to control state exploitation of investors through state based sanctions - this concern is of less relevance to Australia with the *Corporations Act* because of the uniform legislative scheme.

On the basis of this analysis, Easterbrook & Fischel assert that the appropriate contours of a mandatory disclosure regime should be based on addressing the above two concerns. It is argued that disclosure should be standardised for all issuers based on common accounting procedures. The mandatory regime should restrict itself to the disclosure of objective facts (and not for example forward looking information) so as to permit simple verification procedures and to support enforcement rights.

Ultimately, the debate of the information economists and their critics remains very much unresolved.

A cynic might say that the debate has little to do with the real world. The historical overview of fundraising as summarised in Section 1.4 has demonstrated a strongly perceived regulatory need for mandatory disclosure to counter abuses in the securities markets.<sup>340</sup> The theoretical material consistently ignores this dynamic in the development of the securities laws in the key jurisdictions. At its heart, the debate relates to the cost and relevance associated with mandatory disclosure as well as the relevant bargaining strength of investors and issuers. While clear issues of mandatory disclosure of irrelevant information might arise from time to time, the issue of the cost associated with mandatory disclosure is a very subjective matter.<sup>341</sup> The philosophical underpinnings of the information economists has much the same purity of economic analysis that underlies the efficient market hypothesis. In the real world that purity of analysis tends to break down, particularly when the views of behavioural science are introduced instead of economics.<sup>342</sup>

In relation to the relative bargaining strength of investors and issuers, needs for mandatory disclosure may vary from jurisdiction to jurisdiction based on the disciplines that exist in the securities market of that jurisdiction through factors such as the openness of the market for corporate control and the role and influence of institutional investors.<sup>343</sup> A further consideration may be, not only the quality of the mandatory disclosure regimes, but the quality of their enforcement.<sup>344</sup> As outlined above, the arguments of the information economists rely heavily on

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<sup>340</sup> See *Anderson (1974)* at 316 - 331 in this context.

<sup>341</sup> For a more optimistic assessment of that task in the Australian context see *Lawrence (2000)* at 192-4.

<sup>342</sup> For example management employment incentive arrangements being based on short term share price performance may encourage short term opportunism to maximise share prices over rational decision making as to the long term benefits of disclosure.

A further example might be where an entity is in financial difficulty, officers may irrationally take desperate measures to preserve their employment arrangements through non-disclosure.

<sup>343</sup> See F. Easterbrook “*International Corporate Differences: Markets or Law*” (1997) 9 *Jnl of App Corp Fin* 23.

<sup>344</sup> See R. La Porta, F. Lopez de Silanes, A. Shleifer & R. Vishny “*Legal Determinants of External Finance*” (1997) 52 *Jnl of Fin* 1131.

the existence of effective sanctions for fraud and misstatement. That is where the liability rules that are the topic of this dissertation remain pivotal to the analysis. The issue of the quality of enforcement may have particular relevance to Australia, having regard to the small size of its securities markets in world terms and the lack of a strong enforcement record.<sup>345</sup>

The debate as to the need for mandatory disclosure rules has more to do with political objectives than the realities of the operation of the securities markets. Clearly the information economists represent a laissez faire view of appropriate regulation. In that regard the debate in this area can be viewed as reflective of public choice theory and the political process by which different groups compete to impose their will on others.<sup>346</sup>

### **The Role of the Liability Regime: Deterrence**

Both the analysis of the efficient market hypothesis and the arguments of the information economists reinforce the pivotal role of the liability rules in establishing an appropriate disclosure regime. Civil liability rules in this context are generally perceived to perform two functions. First, in providing compensation for those who have suffered loss and, second, in acting as a deterrence device to encourage persons involved in the process to comply with the law (or a “in terrorem” function).

If the sole role of the prospectus regime in Australia was compensatory in nature, on any measure that regime would be found to be wanting having regard to the dismal historical enforcement record.

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<sup>345</sup> See *Lawrence (2000)* at 172-4.

An interesting analogy to this debate in Australia was the introduction in 1994 of a regime of continuous disclosure obligations and sanctions into the *Corporations Act*. These amendments gave legislative backing (including a liability regime) to the continuous disclosure regime contained in the ASX listing rules and imposed a disclosure regime on certain other widely held entities - see the background description in *Blair (1992)*.

A 1996 study of the impacts of the introduction of these provisions found that there was no strong evidence that the reforms had any significant impact on the efficiency of the Australian share market or on the disclosure policies adopted by listed companies - study by Brown, Taylor & Walter attached to Companies & Securities Advisory Committee “*Report on Continuous Disclosure*” (1996) - see Appendix 6 at 4. It was suggested that this result arose because the legislation only imposed a liability regime on listed companies, not a new disclosure regime - See Appendix 7 at 19.

However, with the new economy bubble of 2000 the claim has been made that many entities have disregarded these provisions. The concern that has been raised is both as to the effectiveness of the regulatory provisions as well as with the structure of the liability regime.

In a sense, the lack of enforcement of the continuous disclosure regime is reflected by the lack of enforcement of the fundraising provisions of the Australian securities laws.

<sup>346</sup> See Gunningham “*Public Choice: The Economic Analysis of Public Law*” (1992) 21 Fed L Rev 117 and the analysis at *Blair & Ramsay (1998)* at 76-78.

Loss of investment is as frequent a feature of securities investment as gain. The securities laws are not intended to provide a guarantee of return to investors. Ultimately for a small investor the liability regime cannot provide a meaningful compensatory function, in the absence of effective laws facilitating group recovery through class actions, because the cost of recovery of a claim would exceed the value of the loss suffered.

The deterrence effect of the liability regime was considered to be of pivotal significance to the introduction of the prospectus laws in the United States.<sup>347</sup> Indeed it has been suggested that in the United States context:

“Compensation and loss shifting are essentially irrelevant to the scheme. The draftsmen of the Act regarded civil liability only as a means of coercing those named in section 11 to meet the duties and standards of conduct imposed on them by the Act . . . . from the standpoint of the draftsmen, it was important only that the persons named in section 11 face liability to someone; the selection of the group to be awarded damages was less important.”<sup>348</sup>

Many of the participants involved in the capital raising process are repeat players (professional directors, underwriters and advisors). The imposition of liability on a person in these circumstances can be devastating, both for their ongoing ability to earn from their profession as well as for the reputation they have with the public and their peers. For these reasons the liability rules are well placed to form a deterrence function to ensure the disclosure laws are observed or that there are no misstatements made during the offering process.

The difficulty with this proposition is that there must be a relationship between the record of enforcement and the level of deterrence achieved through the regulatory regime. Unenforced laws will be ineffective because even repeat players are not likely to be deterred by liability concerns. This was a criticism of the Australian system in the 1980s. The enforcement record has hardly improved since then. The question is whether the sanctions in the *Corporations Act* do achieve deterrence against this background.

It is also worth noting that in the general policy analysis of the law of tort there has been an ongoing debate as to whether policy underpinnings based on deterrence are appropriate.<sup>349</sup>

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<sup>347</sup> For a reflection of this sentiment at the time of the adoption of the *Securities Act* 1933 see *Douglas & Bates (1933)* at 173-4 and 216 and *Shulman (1933)* at 227 and 251.

<sup>348</sup> *Dooley (1972)* at 809-10. For judicial authority see *Globus v Law Research Service* 418 F 2d 1276 (1969) at 1288: securities regulation “was designed not so much to compensate the defrauded purchaser as to promote enforcement . . . to deter negligence by providing a penalty for those who fail their duties”. To similar effect see *Feit Case* at 567.

<sup>349</sup> See the analysis at Atiyah “*Accidents, Compensation and the Law*” (2nd Ed, 1975) at 502-14, discussed in the prospectus liability context in *Simmonds (1979)* at 669-672; *Coffee (1977)* at 1221-2.

Deterrence requires an ability to alter behaviour to the required standard of conduct, necessitating an ability to perform to that standard of conduct and an awareness of the potential liability that arises so that the person can modify their behaviour accordingly. In the area of prospectus misstatement this policy concern should not pose a problem having regard to the specificity of the task of prospectus preparation and the skills of the various people involved in the process. However, the point needs to be appreciated in assessing the imposition of liability on persons under the *Corporations Act* so that unreasonable expectations are not imposed on the various categories of persons facing potential liability.<sup>350</sup>

### The Policy Basis for the CLERP Act Initiatives

Having regard to the above analysis, it is interesting to assess the policy underpinnings expressed in connection with the introduction of the fundraising provisions of the *CLERP Act*. The *CLERP Fundraising Paper* based its proposed reforms on so called principles of “capital market efficiency”.<sup>351</sup>

The following general policy assertions were made to justify the proposed reforms:

“Disclosure of material information in an effective way places investors in a position to make more confident assessments about securities without undertaking their own costly enquiries .....

Unless disclosure is mandatory, investors will be unable to distinguish poor investments from promising investments in a cost-effective way. Promoters of bad products are unlikely to voluntarily disclose their flaws. Non-disclosure will result in some sub-optimal investment and an increase in overall search costs for those investors who are prepared to remain in the market. It will dampen investment confidence and economic activity”.<sup>352</sup>

The first observation to be made in connection with the above quote is that no attempt is made to distinguish the information needs of different types of investors. The different information needs of different types of investors are not addressed and the manner in which market efficiency might be said to arise through disclosure is not addressed.<sup>353</sup>

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<sup>350</sup> See *Simmonds (1979)* at 671.

<sup>351</sup> These policy underpinnings are set out in section 2.2 and Appendix B of the *CLERP Fundraising Paper*.

<sup>352</sup> *CLERP Fundraising Paper* at 9.

<sup>353</sup> The more detailed analysis of this issue in the materials makes the following observations:

“The disclosure of sufficient reliable information enables market participants to make confident assessments about securities on offer. Confidence and stability in the market as a whole is achieved and maintained when participants know that issuers will make reliable and

The appropriateness or not of the efficient market hypothesis as a basis of regulation is not mentioned. In addition, no possible concern in relation to inefficiencies caused by irrationality (or how that may be dealt with) is noted.

The policy analysis of the *CLERP Fundraising Paper* further moves to the issue of market incentives for disclosures with a mandatory disclosure regime. While espousing “efficiency” the policy analysis suggests that optimal disclosure requires mandatory disclosure, rather than an endorsement of the views of the information economists. This is elaborated on as follows:

“Fundraisers therefore have an incentive to make the disclosures required to persuade investors that they should invest in them. Fundraisers with good news have the most incentive to make disclosures, because this will encourage investment in them .... Other fundraisers may ultimately have an incentive to disclose bad news in order to avoid an inference that their position is worse than is actually the case.

However, if the market is characterised by a high level of disclosure - and thus a high level of confidence - but disclosure is voluntary then a free rider problem is likely to arise as some fundraisers seek to take advantage of the overall high level of confidence in the market place by seeking funds without adequate disclosure (particularly of bad news). The emergence of the free riders would affect investors confidence in the market, leading to their withdrawal or sub-optimal investment decisions, because they could not discriminate between fully disclosing and free riding fundraisers. While it might be expected that the market would adjust in time, at least to some extent, so that those issuers making sufficient disclosure would attract investment and those making inadequate disclosure would not, this adjustment would occur at the cost of reducing overall confidence in the market.

Information disclosed to the market is supplied free of charge to other participants in the market. A fundraisers competitors and others seeking fresh equity may benefit from the disclosure, but the fundraiser can not charge them for the use of the information. Accordingly, some disclosures have the potential to damage the fundraisers profitability .....

It is therefore likely that fundraisers will not voluntarily disclose some information known or available to them that investors would find useful in making their investment decisions, or will disclose information in a manner that would not facilitate comparisons between competing fundraisers. This is because, in a voluntary regime, issuers would have incentives to make less than full disclosure. Mandatory disclosure rules should therefore aim to elicit the right level of disclosure to sustain market confidence”.<sup>354</sup>

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comprehensive disclosure. Potential investors value disclosure by issuers because that disclosure reduces the information imbalance between the issuer and the investors, and therefore reduces investors search costs”.

*CLERP Fundraising Paper* at 73.

Notwithstanding the failure to identify the possible differential needs of different types of investors the *CLERP Act* restatement reflects positive developments through expanded incorporation by reference provisions for prospectus disclosure - see the discussion in Section 6.2

<sup>354</sup> *CLERP Fundraising Paper* at 75 -6.

It is further suggested that in the absence of such a mandatory disclosure regime not all participants in the market will have the same information.<sup>355</sup>

The policy underpinnings for the *CLERP Act* are therefore based on an amalgam of the arguments that underpin the debate of the information economists and their critics as outlined above. Strangely, while the CLERP was promoted by the new Liberal government as being pro-business and deregulatory in nature (particularly as it applies to small business as will be discussed), the policy rationale was couched not in the language of the information economists but of their critics who would promote more regulation over less. Indeed, other than citing concepts such as “free riders” which might suggest a familiarity with public good arguments, the analysis is very much based on arguments that are strongly criticised by the information economists.

One of the significant initiatives of the *CLERP Act* was to broaden the exemptions from the need to prepare and lodge with ASIC a disclosure document so as to facilitate capital raising by small and medium enterprises, in particular. To do so would seem inconsistent with the policy analysis set out above, particularly where the newly exempted investors (for example wealthy investors)<sup>356</sup> are less able to negotiate for disclosure than institutional investors.

A further difficulty with the analysis contained in the *CLERP Fundraising Paper* is that the analysis is very much put in an argumentative fashion. The complexity of the issues under discussion are not acknowledged and there is no attempt to explain why the particular conclusions were reached against possible countervailing views.

On the whole, the analysis in the materials has a flavour of political double speak, rather than providing a well thought out and reasoned basis for the theoretical policy underpinning that would justify a revision of the legislation. That being said, at least the materials underlying the *CLERP Act* sought to put forward a policy basis for their adoption. No such attempt was made when the *Corporations Law* was enacted.

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<sup>355</sup> *CLERP Fundraising Paper* at 74.

<sup>356</sup> The *CLERP Act* exempts investments made by persons earning more than A\$250,000 per annum or having net assets of more than A\$2 million - CA s.708(9).

## CHAPTER 2

### THE CRIMINAL LIABILITY REGIME

The following 3 chapters provide a general overview and commentary on the *Corporations Act* liability regime as a basis for the more detailed analysis of the position of each participant involved in the capital raising process that will follow.

#### 2.1 BACKGROUND TO CRIMINAL LIABILITY REGIME

Criminal liability is imposed by CA section 728(3) which provides that it is an offence<sup>1</sup> for a person to contravene the requirement<sup>2</sup> that a person not offer securities under a disclosure document if there is:

- a misleading or deceptive statement in the disclosure document (or application form or any document that contains the relevant offer);
- an omission from the disclosure document of material required under the relevant provisions of Chapter 6D; or
- a new circumstance that has arisen that would have required disclosure under the relevant provisions of Chapter 6D if it had arisen before the disclosure document was lodged (the supplementary disclosure obligation).

The offence only arises if the relevant matter is materially adverse from the point of view of an investor.<sup>3</sup>

Certain defences to that potential liability are set out in Part 6D.3 (see Chapter 4).

The section 728 regime marks a departure from the predecessor legislation in various key respects. Criminal liability had been incorporated into the *Corporations Law* in 1991 in similar terms to its predecessor legislation and reflecting the manner that criminal liability for prospectus misstatement had become part of English and Australian statutory law (see Chapter 1).<sup>4</sup>

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<sup>1</sup> The penalty is 200 penalty units or imprisonment for five years or both.

<sup>2</sup> CA section 728(1).

<sup>3</sup> CA section 728(3).

<sup>4</sup> That is, a genesis from the *Larceny Act 1861* (England). See Section 1.4 and also Section 5.4.

The immediate predecessor to section 728 (*CL* section 996) had provided that it was an offence for a person to “authorise or cause the issue” of a prospectus where the prospectus contained a statement that was false or misleading or there was an omission in a material respect, subject to

- a due diligence defence<sup>5</sup>; or
- in relation to an omission, that it was “inadvertent”.

The predecessor to that offence had been section 108 of the 1981 *Co-operative Companies Code*. Section 108 provided that where there was an untrue statement or non-disclosure of required information in a prospectus, any person who authorised or caused the issue of the prospectus was guilty of an offence, subject to 3 defences:

- the untrue statement or non-disclosure was immaterial;
- a due diligence defence in the same basic terms as *CL* section 996;
- in relation to a non-disclosure - that it was inadvertent.

Initially the criminal offence for prospectus misstatement had been contained in the crimes statutes but was also introduced into the English companies legislation in 1948 following recommendations made by the Cohen committee in 1945.<sup>6</sup> A criminal offence for prospectus misstatement was introduced into the Australian companies legislation in 1961, copying the then English legislation.<sup>7</sup>

The criminal offence in the predecessor crimes legislation was expressed (and is continued to be expressed) quite differently to the criminal offence in the companies legislation, even though covering much the same ground. The crimes legislation requires the prosecution to prove guilty knowledge on the part of the relevant director that the relevant statement is false.<sup>8</sup> The Cohen committee had instead recommended that once falsity of a statement had been established, the onus should be on the defendant to establish that they did not know the statement was false and could not have known of its falsity by taking reasonable precautions to ascertain its falsity. That

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<sup>5</sup> “after making such inquiries (if any) as were reasonable, had reasonable grounds to believe, and did until the time of issue of the prospectus believe” that there was no misstatement - section 996(2)(b). In other words, the defence followed the language of the *1890 Directors Liability Act*.

<sup>6</sup> Board of Trade “*Report of the Committee on Company Law Amendment*” (1945, Cmnd 6659) at paragraph 41.

<sup>7</sup> See Section 47 of the *Companies Act* 1961.

<sup>8</sup> See analysis at Section 5.4.

recommendation effectively moved the standard of culpability from guilty mind, analogous to the civil liability tort of deceit, to the 1890 *Directors Liability Act* civil standard of reasonable inquiries.<sup>9</sup> This alteration to the traditional crimes legislation culpability standard was reflected in the 1961 Australian legislation, the 1981 Australian legislation and is reflected in the *Corporations Act*.

It is illustrative of the poor grasp of the alternatives available that Australian prosecuting authorities have continued to proceed to prosecute based on the crimes legislation offence rather than the prospectus offence, despite the clearly lower culpability threshold.<sup>10</sup>

### The Corporations Law

The initial draft of the *Corporations Bill* 1988 was substantially identical to section 108 of the *Companies Code*.<sup>11</sup> However, the confusion of the policy objectives sought to be achieved is demonstrated by the subsequent revision to the section before the legislation was enacted.

At the last moment the section was amended to require proof of materiality by the prosecution as part of the establishment of the offence, rather than reflecting the previous (long established) regime where immateriality was a defence that the defendant would be required to establish.<sup>12</sup> This was peculiar having regard to the fact that at the time the change was made, the public

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<sup>9</sup> The reason given by the Cohen committee for this change was because “if a director signs a prospectus containing a false statement, the case is exceptional” (at paragraph 41).

<sup>10</sup> See for example *CAC (NSW) v Walker* (1987) 11 ACLR 884 (footnote 31 of Chapter 1).

<sup>11</sup> The section included in the Corporations Bill was in the following terms:

- “996. (1) A person shall not authorise or cause the issue of a prospectus in relation to securities of a corporation in which there is a false or misleading statement or from which there is an omission.
- (2) It is a defence to a prosecution for a contravention of subsection (1) if it is proved:
- (a) that the statement or omission was not material;
  - (b) that the defendant, after making such inquiries (if any) as were reasonable, had reasonable grounds to believe, and did until the time of the issue of the prospectus believe, that the statement was true and not misleading or the omission was not material; or
  - (c) where there was an omission from the prospectus - that the omission was inadvertent.”

The criminal offence in section 108 of the 1981 *Companies Code* had also been reviewed by the SIRC Committee. The SIRC Committee considered that, in the context of the other reforms that were proposed, the provisions were adequate. See *SIRC Report* paragraph 6.1.

<sup>12</sup> *Corporations Law Amendment Act 1990*, No. 110 of 1990, Schedule 3 (Substantive Amendments to the *Corporations Law*). The reason given in the explanatory memorandum to the amending legislation for the change was in order to shift the onus of proof onto the prosecution to prove materiality. The explanatory memorandum disclosed that the amendment was sought by the Senate Committee on Scrutiny of Bills. See Explanatory Memorandum to *Corporations Legislation Amendment Bill 1990* at paragraph 1080.

debate was focused on tightening securities law prohibitions in view of the perceived abuses of the 1980s.<sup>13</sup>

In 1991 difficulties were identified with the then structure of *CL* section 996. The term "prospectus", as originally defined in section 9 of the *Corporations Law*, had been extended to mean any written notice or other instrument containing an invitation or offer of securities. It was realised that the definition of the term could therefore extend to unregistered offerings of securities. In the case of an unregistered prospectus there would be no guidance as to what would constitute a material omission for the purpose of the liability provisions. The resolution of this issue was the insertion of section 996(1A) into the *Corporations Law* to exclude prospectuses not required to be lodged under the *Corporations Law*.<sup>14</sup>

### CLERP Act Reforms

The *Simplification Task Force Paper on Fundraising* did not comment on the criminal offence other than to recommend the better alignment of criminal and civil defences and to recommend that the prosecution continue to need to establish materiality of a misstatement.<sup>15</sup> The *CLERP Fundraising Paper* did not focus specifically on the criminal offence, but instead proposed various general reforms to the liability regime.

The Explanatory Memorandum to the *CLERP Bill* makes no comments on changes between *CL* section 996 and the new *CL* section 728.<sup>16</sup> However, the language that eventuated in the *CLERP Bill* proposed a number of significant changes to the criminal offence. Three important changes are discussed below.

The key alteration made by the *CLERP Act* is to change the touchstone of liability from a person that "authorises or causes the issue" of a prospectus to a person that "offers securities".

The difficulty with the term "authorise or cause the issue" in the prospectus liability provisions is not new. The concept of liability attaching to persons who "authorise or cause the issue" of a

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<sup>13</sup> No clear policy reason was given for the change. The change is also inconsistent with the recommendations made in the *SIRC Report* for civil liability. See *SIRC Report* at paragraph 6.5, discussed in section 3.1 below.

<sup>14</sup> *Corporations Legislation Amendment Act (No. 2) 1991* (No. 201 of 1991), Schedule 2 (Amendments to the *Corporations Law* Relating to Fundraising). The explanatory memorandum to the amending legislation noted a broad range of conflicting views as to the desirable scope of the criminal liability sanction and accepted that the criminal sanction should not apply to unregistered offerings. It was further noted that this issue should be a matter for further review from the policy perspective in relation to civil and criminal liability.

<sup>15</sup> Page 8, Proposal 27. In relation to civil liability it is noted that difficulties exist with imposing liability on a person that authorises or causes the issue of a prospectus - at page 16. However there is no further elaboration.

<sup>16</sup> Beyond the changes to the requirement of materiality in section 728(3) - see paragraph 8.29 of the Explanatory Memorandum to the *CLERP Bill*.

prospectus as the sole determinant for identifying the persons who would face potential criminal liability had been introduced into the Australian securities laws in this way in 1961.<sup>17</sup>

The term would appear to have developed over a period of time without any rigorous process of testing its appropriateness to the prospectus liability regime. The first appearance of a similar generic characterisation was the *1890 Directors Liability Act* that imposed liability on directors, proposed directors, promoters and “every person who has authorised the issue of the prospectus”.<sup>18</sup>

The indeterminacy of the meaning of the term “authorise or cause the issue” had given rise to uncertainty of analysis.<sup>19</sup> The term had not been the subject of any meaningful judicial analysis until the case of *NRMA v Morgan* in 1999.<sup>20</sup> A survey of the legal analysis required to assess the likely scope of the term clearly demonstrates the desirability of its removal as the touchstone of liability from a policy perspective.

A number of earlier cases had proceeded on the presumption that directors authorise or cause the issue of a prospectus without analysis.<sup>21</sup> In *NRMA v Morgan*, Giles J said the directors “no

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<sup>17</sup> See section 47 (criminal liability) and section 46(1)(d) (civil liability) of the *Companies Act* 1961 of each Australian state.

<sup>18</sup> Section 3 of the *1890 Directors Liability Act*. The use of the term would appear to have developed from the test of liability adopted by the courts in establishing the tort of deceit. See the tort of deceit cases noted in footnote 21.

The first appearance in New South Wales was section 140(1)(d) of the *Companies Act (New South Wales)* 1936. The 1961 legislation took the “authorise or cause the issue” term and made it the sole determinant of criminal liability and a component of the civil liability remedy. The background materials to the 1961 legislation do not disclose the reasons for the move to this terminology.

<sup>19</sup> See criticism in *Golding (1993)* at 407-8 and *Golding (1997)* at 179-180.

<sup>20</sup> *NRMA Ltd & Ors v Morgan & Ors* (1999) 31 ACSR 435 (SC, NSW, Giles J) at 795-799, on appeal *Heydon & Ors v NRMA Ltd* [2000] NSWCA 374; 36 ACSR 462 (Malcolm AJA, McPherson AJA, Ormiston AJA).

<sup>21</sup> *Flavel v Giorgio* (1990) 2 ACSR 568 (SC of SA, Full Court) (on appeal from decision of Prior J (1989) 15 ACLR 486) (prosecution under section 108 of the *Companies Code* 1981); *Australian Securities Commission v Burns & Ors* (1994) 12 ACLC 545 (FCA, Neaves J) (prosecution under section 108 of the *Companies Code* 1981); criminal proceedings in NSW against Messrs Hamley & Ansett, directors of Budget Corporation Limited (the jury failed to reach a verdict in August 1997); *Registrar of Companies v Brierley & Anor* [1965] NZLR 809 (prosecution under New Zealand *Companies Act* 1955 against a director as a person who “authorised the issue”); *Clark & Ors v Urquhart* [1930] AC 28 (evidence that directors issued prospectus with their authority for purposes of *Companies Act*); *Geipel v Peach* [1917] 2 Ch 108 (civil action against a director as a person who authorised the issue of a prospectus under section 84 of the *Companies Act* 1908 England); *Barrow v De Garis* (1926) 29 WAR 4 (director who voted to approve issue of prospectus “must be taken to be one of those who authorised the issue” for purposes of deceit action); *Andrews v Mockford & Anor* [1896] QB 372 (jury found the directors had authorised a prospectus); *Henderson v Lacon* (1867) LR 5 Eq 249 (directors admitted prospectus issued by their direction and with their authority for purposes of a rescission case); compare with *Hoole v Speak* [1904] 2 Ch 732 (prospectus issued without consent of director did not give rise to liability under *1890 Directors Liability Act* or *1867 Companies Act*); *Weir v Barnett* [1877] 3 Ex D 33 and *Weir v Bell* (1878) 3 Ex D 238 (on appeal to Court of Appeal) (in a deceit action directors who had authorised the appointment of brokers to sell debentures did not authorise, and were not responsible as principals of the brokers for, a fraudulent prospectus issued by the brokers).

See also *Famel Pty Limited v Burswood Management Limited* (1989) ATPR 40-962 (FCA, French J) and the presumption that the trustee of a unit trust will authorise the issue of a prospectus offering units in the trust if the trust deed prohibits the issue of units without its consent.

Under Chapter 6D each director must consent to the disclosure document - section 720.

doubt” authorise and cause the issue of prospectus because they make the decision to release the document.<sup>22</sup> This view was endorsed by McPherson AJA on appeal.<sup>23</sup>

The more difficult issue is whether others involved in the prospectus preparation process would be considered to authorise or cause the issue of the document. Participants such as underwriters will market the offer on behalf of the issuer<sup>24</sup> but do not have the power to make the offer proceed (although by contract they may reserve the right to cancel the offering). Other participants will be required to consent to being named in the document, but have no power to make the offer proceed (or to prevent the offer proceeding if it proceeds without them being named).<sup>25</sup>

The difficulty with the terms is that both “authorise” and “cause” have a range of possible meanings from a concept of formal authorisation through to facilitation of the conduct in question.<sup>26</sup>

The position is not assisted by reference to judicial consideration of the term “authorise” or “cause” as used in other statutory contexts. For example, in considering whether a person has “authorised” a breach of copyright for copyright infringement purposes a broad dictionary meaning of “sanction, approve or countenance” is adopted, being considered the equivalent of permission.<sup>27</sup> Similarly, in the environmental context, statutes that prohibit a person from

<sup>22</sup> 31 ACSR 435 at 797

<sup>23</sup> At paragraph 445 (approved by Malcolm AJA at paragraph 352). McPherson J noted that in *Urquhart v Stracey* [1928] N1 163 at 171 (on appeal *Clark v Urquhart* [1930] AC 28 at 55) it was said that director would authorise a prospectus depending on “how far they were or become responsible for the prospectus” based on factors such as the extent of their knowledge, whether they discussed the drafts and whether they were named.

<sup>24</sup> See Section 6.1

<sup>25</sup> Prior to the enactment of the *CLERP Act* each expert was required to consent to the inclusion of its report - section 1032.

<sup>26</sup> *The New Shorter Oxford English Dictionary* 1993, Clarendon Press defines “authorise” as: “<sup>1</sup> Set up or acknowledge as having authority. <sup>2</sup> Make legally valid. <sup>3</sup> Give formal approval to; sanction, countenance. <sup>4</sup> Vouch for, confirm. <sup>5</sup> Endow (a person, body, etc) with authority; commission. <sup>6</sup> Give legal or formal warrant to (a person or body) to do; empower, permit authoritatively. <sup>7</sup> Of things: give grounds for, justify. <sup>8</sup> to afford a ground for; warrant; justify.”

*The New Shorter Oxford English Dictionary* 1993, Clarendon Press defines “cause” as: “<sup>1</sup> That which produces an effect or consequence; an antecedent or antecedents followed by a certain phenomenon. <sup>b</sup> A person or other agent who occasions something, with or without intent. <sup>2</sup> A fact, circumstance, or consideration which moves a person to action; ground for action, reason, motive; esp. adequate motive or justification. <sup>3</sup> ... <sup>b</sup> A matter of concern; the case as it concerns anyone, the situation. <sup>4</sup> ....”

A consideration of the definitions used in the *Corporations Law* was not particularly helpful in attempting to determine the scope of the term. The word “issue” was expansively defined in section 9 to include “circulate, distribute and disseminate” and “cause” was defined to include “procure”. Those definitions do not take the analysis much further than the position described above. It should, however, be noted that such definitions suggests a broader rather than a narrower construction of each term.

<sup>27</sup> *The University of New South Wales v Moorhouse* [1974-5] 133 CLR 1 at 12-13 (Gibbs J) at 20 (Jacobs J) citing *Falcon v Famous Players Film Company* [1926] 2 KB 474 and *The Corporation of the City of Adelaide v The Australian Performing Right Association Limited* [1928] 40 CLR 481. See also *Nationwide News Pty Ltd v Copyright Agency Ltd* (1996) 136 ALR 273. In England it is considered that to countenance an infringement requires a level of influence over the relevant person to cause the relevant act, rather than merely condoning an act - see *CBS Songs Ltd v Amstrad Consumer Electronics plc* [1988] 1 AC 1013 (rejecting comments made in the 1981 NSW Supreme Court decision of Kearny J in *RCA Corporation v John Fairfax & Sons Limited* [1983], NSWLR 251 that would suggest a broader interpretation - at 259).

“causing” pollution have been considered to require regard to be had to the material consequences of the taking of an action, again suggesting a broad approach.<sup>28</sup> On the other hand, the term “cause” is used in other statutory contexts requires a level of control or dominance over the decision in question.<sup>29</sup>

In *NRMA v Morgan* Giles J considered the potential application of the broader interpretation in the copyright and environmental cases in the context of an argument that the legal advisors to an offering and a barrister giving written advice on legal issues relevant to a prospectus had authorised or caused the issue of the prospectus for purposes of *CL* 996.<sup>30</sup> Giles J considered the statutory context of the criminal sanction with its substantial penalties should suggest “a confined rather than ample scope” to the term.<sup>31</sup> It was considered that the broad view of the copyright cases could not be transposed to *CL* section 996 and that the environmental case law was similarly not helpful.<sup>32</sup>

Giles J stated:

“Conceivably someone such as an underwriter may be regarded as part of the decision making process, because he is able to impose his will on the issuer to ensure the accuracy of disclosure, but someone such as a solicitor will normally not have that control or even be concerned with the content of much of the prospectus. Unless there are unusual circumstances, a solicitor acting as adviser will not authorise the issue of the prospectus.”<sup>33</sup>

On appeal, McPherson AJA said he agreed with the analysis of Giles J.<sup>34</sup> Clearly, from a policy perspective the approach of Giles J in *NRMA v Morgan* is correct because only the persons that

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<sup>28</sup> See *Alphacell Ltd v Woodward* [1972] 2 All ER 475 and *Empress Car (Abertilly) Ltd v National Rivers Authority* [1998] 1 All ER 481, followed in Australia in cases such as *Cooper v ICI Australia Operations Pty Ltd* (1987) 64 LGRA 58; *Window v Phosphate Co-operative Co of Australia Ltd* [1983] 2 VR 287; *Majury v Sunbeam Corporation Ltd* [1974] 1 NSWLR 659.

<sup>29</sup> See *O’Sullivan v Truth and Sportsmen Limited* (1956-7) 96 CLR 220 at 231 (offence of offering or causing to be sold newspapers containing certain material), citing *Watkins v O’Shaughnessy* [1939] 1 All ER 385 at 386-7 (offence of causing a person to use an unregistered motor vehicle).

<sup>30</sup> The prospectus and advisor consents had stated that the lawyers had not authorised or caused its issue. Giles J noted that it was accepted this statement would carry no weight against NRMA - 31 ACSR 435 at 795.

The argument was that the advisors could have prevented the issue of the prospectus if they had warned of the deficiencies in the prospectus by refusing to give sign offs and consents.

<sup>31</sup> 31 ACSR 435 at 797.

<sup>32</sup> *Ibid* at 796 and 799. The other statutory contexts noted in footnote 29 were not referred to.

<sup>33</sup> *Ibid* at 797.

<sup>34</sup> At paragraph 446.

are able to determine the outcome of decisions in relation to disclosure should face liability.<sup>35</sup>

The decision left ambiguous the position of underwriters<sup>36</sup>.

In the *Corporations Law* context, the continued use of the term was unfortunate in that the *SIRC Report* had recognised that the ambiguity of this term was a good example of the interpretative problems posed by the civil liability provisions of section 107 of the *Companies Code* (the same term being used in that section). The assumption made by the committee was that it was possible the term had a very wide meaning.<sup>37</sup>

The *CLERP Fundraising Paper* had quite correctly identified that liability based on this concept gave rise to uncertainty and that removal of the concept would avoid uncertainty, focus liability on those who should control the process and reduce compliance costs.<sup>38</sup>

As such, the removal of the term from Chapter 6D with the enactment of the *CLERP Act* was a welcome development.

Under section 728 the prohibition is now linked to the person offering securities. Of the persons involved in the prospectus preparation process, it would seem that only the issuer or seller of securities (as the case may be) makes such an offer. For purposes of Chapter 6D the person who offers securities is the person who has the capacity or who agrees to issue or transfer the

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<sup>35</sup> In the quote referred to above it can be suggested that the role of the modern securities lawyer is underplayed to the extent it suggests the lawyer will not "be concerned" with disclosure, but the sentiment is correct.

<sup>36</sup> The orthodox view in securities law circles was that the underwriter will not authorise or cause the issue of a prospectus (unless the underwriting is a "bought deal" with the underwriter onselling to investors) - see *Golding (1993)* at 408; Gower "*The Principles of Modern Company Law*" 1957, Second Ed, Sweet & Maxwell at 308; *Folk 1 (1969)* at 15; *Dooley (1972)* at footnote 89.

In *Heydon & Ors v NRMA Ltd & Ors* (2001) 36 ACSR 462 McPherson AJA referred to a decision that would suggest a broader interpretation (at paragraph 445, approved by Malcolm AJA at paragraph 352). The decision is *Howell v Dering* The Times April 30, 1914 where it was reported that Bailache J said that a broker named in a prospectus would be liable as having authorised it if it had "means of checking the statements and a real interest in the company, such as an issuing house". The jury found the broker had not so authorised the prospectus: *Howell v Dering* [1915] 1 KB 54.

If the statement of principle in *Howell v Dering* were correct it would be difficult to distinguish the position of underwriters from other advisors, therefore undermining to views expressed by Giles J and McPerson AJA in the *NRMA* case.

<sup>37</sup> "It is possible that this phrase has a very wide meaning - for example, in sub-sections 107(2) and (3), experts and professional advisers and the like are protected from the possibility that by virtue only of being named or having a report included, they might be caught within its scope. Whether or not that is the case, nobody really knows."

*SIRC Report* at paragraph 6.2. It is odd that the *SIRC Report* did not identify the same difficulty with section 108 (clearly there can be no difference in principle between the civil liability and criminal liability provisions).

<sup>38</sup> *CLERP Fundraising Paper* at 45 - 6. Proposal No. 13 of the *CLERP Fundraising Paper* was therefore that the persons liable under the *Corporations Law* should not include persons who authorise or cause the issue of the prospectus unless they are liable as directors or in some other capacity.

The Lonergan Committee had also recommended in 1992 that the ambiguity of the term should be removed - in that case restricting the meaning of the term to directors, underwriters, promoters and secondary sellers (*Lonergan Committee Report* at paragraphs 25 and 229).

securities on acceptance.<sup>39</sup> As such, it would seem directors or underwriters are not such a person, and other advisers are clearly not such a person.

What is not clear from this analysis is that removing the risk of primary criminal liability from directors or underwriters is a good thing from the policy perspective. Clearly, an ongoing debate rages in the academic literature as to the appropriateness of the imposition of corporate criminal liability on companies, as distinct from the imposition of criminal liability on individual's involved in corporate decision making.<sup>40</sup>

What is remarkable is that the *CLERP Act* opted for this liability formulation without any apparent regard to these policy issues.<sup>41</sup> This aspect of the *CLERP Act* reforms reflects poorly on the reform process.

Directors face continuing primary criminal liability under the state crimes legislation.<sup>42</sup> A historical comparative analysis would have clearly identified the need to address the issue of director liability. Both the *Larceny Act* 1861 and the *1890 Directors Liability Act* were framed so that directors and officers were the primary targets for liability. That was also clearly contemplated by the regime that imposed liability on persons who authorised or caused the issue of a prospectus. The retention of primary criminal liability for directors would seem to have a sound policy backing.

In addition, for the reasons set out in Chapter 8, imposition of primary criminal liability on underwriters can be argued to have a sound policy basis.<sup>43</sup>

It would seem that the drafters of the *CLERP Act* overlooked this issue in drafting the *CLERP Act* because the result is inconsistent with the general policy proposal set out in the background materials that the corporation, its directors and underwriters should be liable to investors for misleading statements in a prospectus, subject to the availability of a due diligence defence.<sup>44</sup>

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<sup>39</sup> CL Section, 700(3).

<sup>40</sup> See for example the survey of the literature referred to in W. S. Laufer "Corporate Liability, Risk Shifting and the Paradox of Compliance" (1999) 52 Vand L Rev 1343 (particularly at 1350 - 1) and V. S. Khanna "Is the Notion of Corporate Fault a Faulty Notion?: The Case of Corporate Mens Rea" (1999) 79 B U L Rev 355.

<sup>41</sup> Indeed the *CLERP Fundraising Paper* had specifically recommended director liability - see footnote 38 above.

<sup>42</sup> See Section 5.4.

<sup>43</sup> For example, in 1992 the *Loneragan Committee* had recommended underwriter liability - see footnote 38 above.

The *SIRC Report* had similarly suggested that underwriters be treated as persons that authorise the issue of a prospectus - *SIRC Report* at paragraph 6.3.1.

<sup>44</sup> *CLERP Fundraising Paper*, Proposal No. 13, page 45.

As such, it can be argued that the *CLERP Act* amendments go too far in relaxing primary criminal liability for the classes of person involved in the prospectus preparation process.

The second significant change implemented through *CA* section 728 was to change the requirement of materiality in relation to a misstatement to a requirement that the misstatement be materially adverse from the point of an investor. The impact of this change on the historic concept of materiality is discussed in Section 2.5 below. However, the redrafting of the section generated no debate as to whether the change made in 1991 from requiring materiality to be pleaded as a defence, as compared with an element to be established in a prosecution, was appropriate.

What is disturbing is the apparent lack of rigour by which this change was made in 1991 without reference to any public debate or policy analysis,<sup>45</sup> particularly where the objective was to tighten the legislative requirements. That being said, the significance of a reversal of the onus of proof on this issue, particularly where there is no enforcement record of difficulty with the issue, suggests the change is not an important issue.

The third significant change implemented through section 728 was to conform the criminal and civil due diligence defences applicable to prospectus misstatement. The criminal remedy had only ever reflected the basic due diligence defence as set out in the *1890 Directors Liability Act*. However, the nature of the due diligence defences in the civil liability regime had developed to reflect a much more complicated regime.<sup>46</sup> To the extent that the criminal offence could be interpreted to have stricter requirements in terms of the availability of defences as compared to the civil liability regime, that is clearly inappropriate from a policy perspective.<sup>47</sup> An appropriate structure of sanctions should reflect criminal liability having a higher degree of culpability than civil liability, not the reverse.<sup>48</sup>

As such, the alignment of the defences in the way achieved through section 728 is desirable from a policy perspective as compared to the position under *CL* section 996.

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This position should be contrasted with the 2001 Singapore *Companies Act* which broadly has copied the Australian criminal remedy (section 56) but has opted for specifying the same list of persons that face civil liability (the issuers, directors, underwriter and persons making statements in the prospectus - section 56(2)).

<sup>45</sup> See footnote 12 above.

<sup>46</sup> See Section 4.1 analysis below.

<sup>47</sup> See the analysis in *Golding (1997)* at 181 - 2.

<sup>48</sup> See Section 2.3 analysis below.

## Accessory Liability

Even if the criminal liability provisions of the *Corporations Act* are not applicable to a participant involved in the preparation of a prospectus, that person will face possible accessory liability under the criminal law. Section 11.2 of the Commonwealth *Criminal Code* applies to any contravention of the *Corporations Act*.<sup>49</sup>

Section 11.2 of the *Criminal Code* is in the traditional terms of providing it is an offence if a person has aided or abetted a breach of the criminal law.<sup>50</sup>

Accessory liability under Section 11.2 is returned to in Chapter 9 for detailed analysis. The outcome of that analysis is that accessory liability will be predicated upon knowledge of the essential matters constituting the offence in question and a degree of participation in the contravention. This is clearly a lower culpability standard to that for primary criminal liability.

## 2.2 COMPARATIVE ANALYSIS WITH OTHER KEY JURISDICTIONS

A comparative analysis with the criminal liability provisions of other key jurisdictions is instructive. The comparative analysis shows a divergence of approach between the United States and Commonwealth jurisdictions.

### United States

The criminal offence under United States law is generic to any breach of the *Securities Act 1933* rather than to prospectus misstatement specifically. Criminal liability is provided for in Section 24 in the following terms:

“Any person who wilfully violates any of the provisions of this title, or the rules and regulations promulgated by the Commission under authority thereof, or any person who wilfully, in a registration statement filed under this title, makes any [misstatement] shall upon conviction be fined.”<sup>51</sup>

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<sup>49</sup> This follows from the *Corporations Act* being a Commonwealth Act.

The *Criminal Code* replaced the prior *Crimes Act 1914* where accessory liability was imposed by section 5. Section 11.2 of the *Criminal Code* contains a more detailed elaboration on accessory liability than had been contained in section 5.

Under the *Corporations Law* the constitutional analysis was more complicated in its application to accessory liability under Commonwealth law- see *Australian Securities & Investments Commission v Vis & Ors* (2000) 35 ACSR 416 (SCSA, Doyle CJ, Prior & Williams JJ) at 435 and *R v Macleod* (2001) 39 ACSR 189 (SC NSW, Mason P, Simpson J and Newman J) at 195 - 6.

<sup>50</sup> “Any person who aids, abets, counsels, or procures, or by any act or omission is in any way directly or indirectly knowingly concerned in, or party to, the commission of any offence against any law of the Commonwealth, whether passed before or after the commencement of this Act, shall be deemed to have committed that offence and shall be punishable accordingly.”

<sup>51</sup> The fine is US\$10,000 or imprisonment for 5 years or both.

The concept of “wilfulness” therefore underpins the criminal liability provisions.<sup>52</sup> The Supreme Court has made it clear that knowledge is the essential determinant of wilfulness. The test is:

“A realisation on the defendant’s part that he was doing a wrongful act.....that the act be wrongful under the securities laws and that the knowingly wrongful act involves a significant risk of effecting the violation that has occurred.”<sup>53</sup>

It is generally considered that specific intent to defraud is not required for a prosecution under these provisions.<sup>54</sup>

A wilfulness standard of liability imposes a higher threshold than the standard of section 728 and its imposition of criminal liability if a material misstatement is established, subject to due diligence defences. It will be argued in Section 4.2 that liability tempered by a due diligence defence is essentially equivalent to a negligence standard of culpability. Negligence does not require realisation by the defendant that the act in question was wrongful.

### United Kingdom and other Commonwealth Countries

The common genesis of the development of the English criminal liability regime for prospectuses from recommendations made by the Cohen committee in 1945 has been discussed above.

Prior to 2002 the *Financial Services Act 1986*<sup>55</sup> and the *Public Offers of Securities Regulations 1995*<sup>56</sup> continued to provide for that criminal law regime and were therefore reflective of the pre-CL Australian regime. Under the UK provisions any person who “authorised the issue” of a prospectus with an “untrue statement” was guilty of an offence.<sup>57</sup> There was a simply expressed due diligence defence where there is reasonable grounds for belief in the truth of the statement or where the statement is immaterial.

From 1 December 2001, the *Financial Services and Market Act 2000* deletes the specific prospectus criminal offence and opts for a more general offence relating to misstatements in the securities law context. The offence, contained in section 397 of the *Financial Services and Market Act 2000*, is based on section 13 of the *Prevention of Fraud (Investments) Act 1958* of

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<sup>52</sup> In contrast under the criminal offence provision of the *Securities Exchange Act 1934*, a “wilfully and knowingly” standard applies (Section 32(a)). The distinction, if any, between the two tests is a matter of some debate - see *Loss & Seligman (1995)* at 1167-9.

<sup>53</sup> *United States v Peltz* 433 F 2d 48 (2d Cir 1970) cert den 401 US 955 at 55 (Judge Friendly).

<sup>54</sup> See for example *United States v Chiarella* 588 F 2d 1358 (2d Cir 1978) at 1370-1.

<sup>55</sup> Section 70.

<sup>56</sup> Regulation 16.

<sup>57</sup> Continuing the terminology first adopted for civil liability with the *1890 Directors Liability Act*.

England. The section imposes liability on a person who knows a statement to be misleading or deceptive or recklessly makes a statement that is misleading, false or deceptive. This provision is similar to section 1041F of the *Corporations Act* described in section 5.2 below. As such the United Kingdom has moved from an offence subject to a due diligence defence to a deceit standard of culpability.

Most other jurisdictions based on the Commonwealth model follow the traditional structure.<sup>58</sup> On the other hand, jurisdictions that have copied the United States legislation tend to follow that model. For example, in Canada the remedy is generic to a breach of the securities legislation rather than focusing directly on prospectus misstatement. However, the regime is more complex than a wilfulness standard, although it leads to a similar result.<sup>59</sup>

### 2.3 THE APPROPRIATE STANDARD OF CRIMINAL CULPABILITY

A comparative analysis therefore establishes two different approaches to criminal liability. First, the higher culpability of a “wilfulness” standard reflected in the United States approach and, second, the deemed liability subject to a due diligence defence reflected in the Australian and traditional Commonwealth approach, equivalent to a negligence standard of culpability.<sup>60</sup>

The issue from a policy perspective is what regime is more appropriate for criminal liability.

At the outset of this dissertation it was noted that a key deficiency identified by some commentators with the operation of Australia’s corporate and securities laws was the blurring of the criminal/civil boundary through the imposition of the same level of culpability for both criminal and civil offences. Section 728 and 729 of the *Corporations Act* have in large part

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<sup>58</sup> For example in New Zealand section 58 of the *Securities Act* 1978; section 40A of the Hong Kong *Companies Ordinance* (CAP 32).

<sup>59</sup> In Ontario (and most other Canadian provinces and territories) if a statement is made to the commission or is contained in a lodged document that is misleading, untrue or contains omissions, a “general offence” may arise for the person making the statement (*Ontario Securities Act* RSO 1990 Section 122(1)). The offence is one of strict liability but due diligence is a defence based on reasonable diligence and lack of knowledge of the misstatement (See the principles of *Rv City of Sault Ste Marie* [1978] 85 DLR (3ct) 161 and *Ontario Securities Act* RSO 1990 Section 122(2)). In addition, any director or officer that authorises, permits or acquiesces in such an offence will be liable if it is proven they had knowledge of the commission of the offence (*Ontario Securities Act* RSO 1990 Section 122(3)). It is generally considered that the due diligence defence will also be available in these circumstances - see *Johnston & Rockwell* (1998) at 215-6).

There are also federal sanctions under the *Criminal Code* of Canada (RSC 1985 c. C-44). In addition to general fraud and false statement offences, it is an offence to distribute a prospectus, statement or account if it is a probable consequence that the recipient will be deceived (*Criminal Code*, section 400). The criminal standard of actual knowledge applies (For analysis see *Johnston & Rockwell* (1998) at 216-8).

<sup>60</sup> It should be noted that the effect of limiting liability under *CA* s. 728 to the issuer or seller of securities means other participants in the capital raising process (in particular, directors, face liability as accessories). As discussed above, accessory liability is predicated on knowledge.

exaggerated a blurred boundary by providing for potential liability that is described in the same basic terms and by introducing common defences.

The question arises as to whether the blurred boundary is appropriate from a policy perspective. It would seem from a survey of the academic material that such a blurred boundary is not desirable. This was not an issue discussed in the background materials to the original *Corporations Law* or the *CLERP Act*.

### **Justification for Imposing Criminal Liability**

The first issue to be addressed in this context is does prospectus misstatement justify the imposition of a criminal liability regime? The antecedents of the offence are in principles of tort, rather than principles of crime.

A full debate as to an appropriate definition and model of criminality is well beyond the scope of this dissertation. The orthodox view is that criminal laws generally apply to acts in violation of “public laws” while harm to individual rights is adequately protected by civil remedies.<sup>61</sup> Traditionally criminal sanctions can be justified on alternative theories of rehabilitation, incapacitation, deterrence and retribution.<sup>62</sup> The first three of these theories should be seen as a way of fashioning socially desirable consequences where the sanctions imposed should be approached from the perspective of ensuring the desired outcome is achieved.<sup>63</sup> The last theory, retribution, is based on concepts of moral culpability where a sanction should only be imposed if blameworthiness is established.<sup>64</sup>

The argument has already been put that the sanctions contained in the prospectus laws should be considered as primarily performing a deterrence function. The generally held view is that the imposition of criminal sanctions in relation to corporate activity should be seen as advancing deterrence goals, and that this is especially true of the securities laws.<sup>65</sup> Even so, it is considered that retribution has some element in an appropriate consideration of the imposition of criminal sanctions in the corporate context.<sup>66</sup>

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<sup>61</sup> See J.W. Blackstone “*Commentaries*” \*5 discussed in *Drane & Neal (1980)* at 402-3.

<sup>62</sup> *Note (1979)* at 1231 citing H. Packer “*The Limits of the Criminal Sanction*” (1968).

<sup>63</sup> Described as the “consequential” theory of punishment. See *Note (1979)* at 1231 - 2.

<sup>64</sup> Described as the “retributive” theory of punishment. See *Note (1979)* at 1232-3.

<sup>65</sup> See *Note (1979)* at 1235 - 7.

The relevance of the above analysis is that to the extent that the criminal sanction for prospectus laws pursues a deterrence function, it is appropriate that the criminal remedy is pitched at a level to achieve appropriate deterrence. The fixing of the CA section 728 regime of liability at a culpability standard of negligence would not normally be appropriate for criminality. However the fixing of liability at such a culpability level might be considered to be justified if it achieved the appropriate deterrence outcome.

On the other hand, if the sanction were to be considered in retributive terms a negligence culpability standard would be inappropriate as it does not impose sufficient requirements of blameworthiness as a component of the remedy.<sup>67</sup>

As such, a standard that requires no finding of wrongful intent may be effective at deterring illegal behaviour, but will not sit well with the policy underpinning that retribution should be based on the establishment of appropriate blameworthiness. Similarly requirements that a crime be committed wilfully or knowingly accord with retribution policy, but may prove inadequate in providing for the deterrence of corporate crime.<sup>68</sup>

The conclusions of this analysis in terms of the standard of criminal culpability in CA section 728 is somewhat unclear, involving as it does a value judgment as to what level of conduct achieves sufficient deterrence. However, it is clear that in 1945 the Cohen committee thought deterrence required a moving of the line from a fraud standard to a negligence standard of culpability.

### The Tort/Crime Boundary

Consideration of the criminal sanction for prospectus misstatement cannot be properly considered without its contradistinction to the civil liability regime in section 729.<sup>69</sup> The issue is whether it is appropriate that the same standard of culpability should apply to both regimes, even if the fixing of the criminal sanction at a particular level of culpability is appropriate from a deterrence perspective.

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<sup>66</sup> See McAdams "The Appropriate Sanctions for Corporate Criminal Liability: An Eclectic Alternative" (1977) 46 *Uni Cin L Rev* 989 at 992. If the Australian pursuit of certain entrepreneurs in the 1990s (particularly West Australians and Queenslanders) are considered, that claim would seem to have some basis.

<sup>67</sup> Blameworthiness should be considered to require two essential preconditions: the ability of the actor to make decisions and an inexcusable failure to perform the assigned task - See *Fisse & Braithwaite (1988)* at 483.

<sup>68</sup> *Note (1979)* at 1244.

<sup>69</sup> For general analysis see *Drane & Neal (1980)*.

The appropriate boundary between the imposition of criminal and civil statutory liability has frequently been cited as hazy.<sup>70</sup> In addition it has been suggested that colonial legislatures often chose between civil and criminal penalties “in a wholly capricious way”.<sup>71</sup> That observation has a ring of resonance to the Australian experience where the *Corporations Act* contains a plethora of provisions, including Chapter 6D.3, where the same conduct has identical potential criminal and civil consequences.

There are two features to the tort/crime boundary that are of fundamental relevance in this respect.

The first observation is that the general law imposes a fundamentally different regime in terms of the procedural protections afforded to the accused in a criminal prosecution as compared to a civil action.

The second observation is that for the typical professional person subject to a criminal prosecution, the consequences of that prosecution being undertaken (irrespective of the outcome of the proceedings) are potentially devastating in terms of career, perhaps more so than for many other classes in society.<sup>72</sup> As such, it can be expected that the threat of prosecution itself imposes a significant degree of deterrence on participants involved in the capital raising process.

On the other hand, the combination of these two observations can make it difficult to achieve convictions against successful people where the statute does not predicate liability on acts that the general public would consider immoral.<sup>73</sup> This problem is exacerbated by the complexity of many alleged corporate crimes and the inability of untrained persons to follow the issues involved.<sup>74</sup> In the prospectus context, that view can be suggested by the unsuccessful prosecutions in the 1990s against the professional advisors in both the Budget Corporation

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<sup>70</sup> See *Note (1979)* at 1300 - 1.

<sup>71</sup> See Frankfurter & Corcoran “*Petty Offences and the Constitutional Guarantee of Trial by Jury*” (1926) 39 Harv L Rev 917 and 937 and *Note (1979)* at 1302 footnote 13.

<sup>72</sup> “To the businessman ..... prison is the inferno, and conventional risk-reward analysis breaks down when the risk is jail” - Liman “*The ‘Paper Labels Sentences’ Critiques*” (1977) 86 Yale LJ 630 at 630 - 1; See also *Note (1977)* at 1245 and *Ogren (1973)* at 962.

For a contrary view that violation of securities laws does not necessarily lead to loss of status among business peers see E. H. Sutherland “*White Collar Crime*” 1949, Dryden Press at 219 discussed in B. M. Ho “*Rethinking the System of Sanctions in the Corporate and Securities Law of Hong Kong*” (1997) 42 McGill 2J 603 at 632.

<sup>73</sup> *Note (1979)* at 1310 - 1; GFK Santow “*Regulating Corporate Misfeasance and Maintaining Honest Markets*” (1977) 51 ALJ 541 at 555.

<sup>74</sup> See *Ogren (1973)* at 969; G.F.K. Santow “*The Trial of Complex Corporate Transgressions - The United States Experience and the Australian Context*” (1993) 67 ALJ 265.

Limited and the White Industries Limited matters noted in Chapter 1.<sup>75</sup> A failure to establish a record of convictions undermines the threat from possible criminal prosecutions felt by participants involved in the securities markets.<sup>76</sup>

As such, this consequence can work against the effectiveness of the deterrence objective of the criminal laws. Similarly, the 1989 Cooney Committee Report stated in the Australian context:

“When gaol terms are provided for breach of the law but the courts are disinclined to impose them because they seem too draconian, the law tends to fall into disrepute”.<sup>77</sup>

The above considerations would suggest that a blurring of the tort/crime boundary is undesirable and that a better legislative response would be to provide for a criminal remedy that meets community expectations of blameworthiness, to be activated only when that there is a perception that a higher culpability trigger has been breached by the person in question, with more garden variety misstatements vigorously enforced through civil liability provisions or lesser sanctions.

### The Debate as to Remedies

In the last decade the debate as to the appropriate policy underpinnings for criminal and civil sanctions has not only extended to standards of culpability and the interface between criminal and civil standards, but also the appropriate remedies that should be imposed so as to discourage misconduct.

The traditional criminal sanction for prospectus misstatement is and has been the alternatives of gaol or fines.<sup>78</sup> With a reluctance of courts and juries to impose gaol terms on corporate offenders, fines have tended to be an ineffective remedy to support either deterrence or retribution objectives, because they tend to be imposed at levels that do not impose a burden on the offender.<sup>79</sup> Calls have been made from a number of quarters to develop new sanction regimes that are more attuned to modern commercial realities.<sup>80</sup>

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<sup>75</sup> For example, in *Cwth DPP v Stevenson & Smithers* (unrep 17 October 1994) (Local Court Sydney) the judge had received impressive character evidence from members of the business community as to the defendant solicitor and defendant accountant. This material would seem to have been influential in the judge's findings that they did not have knowledge of a prospectus misstatement (knowledge was required for liability as an accessory - see Section 9.5 below).

<sup>76</sup> See R. Tomasic “*Corporations Law Enforcement Strategies in Australia: The Influence of Professional, Corporate and Bureaucratic Cultures*” (1993) 3 Aust Jnl of Corp L 192 at 220 and 226; *Ogren* (1973) at 974-5.

<sup>77</sup> Senate Standing Committee on Legal & Constitutional Affairs “*Company Directors' Duties, Report on the Social and Fiduciary Obligations of Company Directors* (AGPS, 1989) (the “*Cooney Committee Report*”).

<sup>78</sup> Footnote 1 above.

<sup>79</sup> In that the rich can afford to pay them while the poor cannot pay them because they cannot afford to do so - see *Ogren* (1973) at 962 and 967.

In the United States there has been a vigorous debate among the information economists as to the desirability of using fines as the primary criminal sanction, calculated in accordance with economic principles so that the fine is structured at a level where the marginal cost of the fine achieves the deterrence objective.<sup>81</sup> However, as was the case with the debate of the information economists outlined in Section 1.6 on mandatory disclosure, this debate has strong objectors.<sup>82</sup> In addition, a very relevant consideration is that in the corporate area, business crimes are frequently driven by desperate behaviour (for example to avoid economic disaster) rather than on purely rational grounds.<sup>83</sup> As such, the relevance of this literature to the debate should be considered somewhat suspect.

Having regard to the considerations outlined above, over the last decade a number of Australian commentators and review committees have called for greater flexibility in relation to criminal sanctions so as to encourage deterrence.<sup>84</sup>

### Role of DPP

An enforcement issue peculiar to Australia is the distinction between the role of ASIC as general regulatory body responsible for the securities markets and the Commonwealth Director of Public Prosecutions (DPP) as prosecuting body in enforcing the criminal liability provisions of the *Corporations Act*.

The operation of the *Corporations Law* during the 1990s exhibited a number of instances where effective prosecutions were hampered by the overlap between the roles of ASIC and the DPP.<sup>85</sup> Initial investigation work is undertaken by ASIC. If prosecution is considered justified a brief is sent to the DPP. The DPP then undertakes its own inquiries to assess whether charges should be laid and has responsibility for any subsequent prosecution.

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<sup>80</sup> See for example *Tomasic (1992)* at 106.

<sup>81</sup> See R. Posner "An Economic Theory of the Criminal Law" (1985) 85 Columbia L R Rev 1193; F.H. Easterbrook & D.R. Fishel "Optimal Damages", Chapter 12 in "The Economic Structure of Corporate Law" (1991).

<sup>82</sup> See for example *Coffee (1980)*. Coffee argues that the economic basis for the calculation of optimal fines to support such a structure is too elusive (at 441-2) and to achieve deterrence it is the threat rather than the penalty itself that is critical (at 426-8).

<sup>83</sup> *Ogren (1973)* at 974.

<sup>84</sup> See the survey of material in *Tomasic (1992)*.

<sup>85</sup> The most notorious example was the criminal investigation into the so-called "Yannon" manner. The events in question took place in the late 1980s. An ASIC inquiry commenced in September 1995 (page 14 of ASIC Annual Report 1995/96). In 2000, it was announced that the DPP would not lay charges. ASIC described the time taken as "clearly unsatisfactory" and that it was reviewing the whole process in consultation with the DPP (page 12-13 of ASIC Annual Report 1999/2000).

This process leads to various criticisms. First there is duplication of inquiry by ASIC and the DPP. Second there is delay caused by the discontinuity between the ASIC and DPP procedures. Third the DPP does not involve a dedicated resource for the enforcement of corporate criminal actions and may lack some of the experience of the securities markets and appropriate skills to successfully prosecute these types of action.

Of course, the issues raised here relate to enforcement of the criminal sanctions in the *Corporations Act* generally and not just CA s.728.

### Some Conclusions

The above analysis is only intended to outline the broad contours of the sanctions debate. A key issue posed in this dissertation is the question of whether the lack of enforcement history of the prospectus liability rules undermines objectives of deterrence in the Australian market.

It should be a matter of concern that the only two prospectus misstatement prosecutions in the last decade were unsuccessful. While it may be that the wrong cases were chosen for prosecution, there must also be a real concern that the lack of a requirement to establish a level of blameworthiness beyond negligence encourages judges and juries to acquit because they do not see sufficient blameworthiness to justify *gaol*.

In that respect the findings of the Cohen committee in 1945 are open to challenge.<sup>86</sup> This at the very least is a debate worth having. It was not a debate had in the development of the *Corporations Law* and the *CLERP Act* and that is likely to have been a mistake.

Beyond the measure of culpability, there is a more fundamental debate as to the appropriateness of traditional models of criminal liability for this type of securities liability. In the United States it has been argued that the SEC's relative lack of enforcement resources (which would seem to be huge by contrast to Australian resources), results in insufficient deterrence being achieved.<sup>87</sup> The limited available resources lead to fewer investigations and enforcements actions than are optimal and pressure to settle rather than pursue expensive trials.

Clearly Australia has a very poor prosecutorial record in the fundraising area. It can be argued that a more helpful policy debate over the decade of the 1990s would have been to explore the

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<sup>86</sup> Indeed, this was the recommendation of the Jenkins committee in England in 1962 - see discussion at footnote 82 of Chapter 1. That recommendation was not subsequently acted upon.

<sup>87</sup> *Langevoort (2001)* at 28.

policy underpinnings of criminal liability and the issue of whether alternative remedies may result in better deterrence outcomes.

The foregoing is not to suggest that there were not significant developments in the area of sanctions for securities law matters during the 1990s. The problem is that none of these developments have been applied (or yet considered for application) to the fundraising provisions of the *Corporations Act*.

Commencing in 1993 a contravention of certain provisions of the *Corporations Act* may give rise to sanctions under the civil penalty provisions of the legislation.<sup>88</sup> If there has been a contravention of certain provisions of the legislation, ASIC (and no other person) may apply for a declaration of contravention.<sup>89</sup> Civil liability rules of evidence and procedure apply.<sup>90</sup> The consequence of the establishment of a contravention are sanctions involving fines and potential compensation orders.<sup>91</sup> The availability of a fine remedy based on civil liability standards is clearly consistent with the above analysis of appropriate sanctions, providing much greater flexibility.<sup>92</sup>

It would seem that not thought was given to the potential application of this regime to contraventions of Chapter 6D. This is odd because a key perceived reason for the adoption of the civil penalty provisions was to provide a more meaningful sanction for breaches of director duties. Chapter 6 describes the close analogy of the directors liability under Chapter 6D for prospectus misstatement to the director duty of care, skill and diligence.<sup>93</sup>

The second key development has been a codification of the Commonwealth criminal law that applies to contraventions of the law of the Commonwealth that took effect from December

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<sup>88</sup> Part 9.4B of the *Corporations Act* (restated in 1999).

For criticism of the enforcement record in the first 3 years see H. Bird "The Problematic Nature of Civil Penalties in the Corporations Law" (1996) 14 C&SLJ 405. For a contrary view see M. Gething "Do We Really Need Criminal and Civil Penalties for Contraventions of Directors Duties?" (1996) 24 ABLR 375.

<sup>89</sup> Section 1317J(1) and (4).

<sup>90</sup> Section 1317L. This is seen by many commentators as the key advantage - see H. Bird *Supra* at 418.

<sup>91</sup> Section 1317G and section 1317H (the company can seek compensation under these provisions) - see section 1317J(2)).

<sup>92</sup> For support for this approach see *Tomasic (1993)* at 216 - 220; R. Tomasic "Corporations Law Enforcement Strategies in Australia: The Influence of Professional, Corporate and Bureaucratic Cultures" (1993) 3 Aust Jnl of Corp L 192 at 216-220 and 226; V. Goldwasser "The Regulation of Stock Market Manipulation - A Blue Print for Reform" (1998) 9 Aust Jnl of Corp L 109 at 112 and 118-122; V. Goldwasser "CLERP 6 - Implications and Ramifications for the Regulation of Australian Financial Markets" (1999) 17 C & SLJ 197 at 210. Such a regime had received strong support from the Senate Standing Committee on Legal and Constitutional Affairs "Company Directors Duties: Report on the Social & Fiduciary Duties & Obligations of Company Directors" (ALPS, 1988) at Chapter 13.

<sup>93</sup> Made a civil penalty provision by section 1317E(1)(a).

2001.<sup>94</sup> The *Criminal Code* codifies the general principle of criminal responsibility applicable to any breach of a Commonwealth act, irrespective of how the offence is created.<sup>95</sup> The *Criminal Code* contains statutory definitions of intention, recklessness and negligence for purposes of fault elements that may be specified in an offence<sup>96</sup> and default rules that apply to the imposition of culpability requirements for establishing the contravention of an offence.<sup>97</sup>

The *CLERP Act* amendments did not attempt to deal with the *Criminal Code* and the regime it introduced.<sup>98</sup> Instead, the effect of the introduction of the *Criminal Code* has been to undermine the operation of the criminal offence contained in section 728(3) as compared to the position before the adoption of the *Criminal Code*.

Section 728(3) provides that the offence requires the establishment of three component elements. Those elements are a contravention of section 728(1), being first the offering of securities under a disclosure document and second a situation where the disclosure document contains a misstatement. Third the misstatement must be materially adverse from the point of view of an investor. As such, section 728(3) does not contain a “fault element” within the meaning of the *Criminal Code*.<sup>99</sup>

Section 5.6 of the *Criminal Code* specifies “default fault” elements where an offence does not specify a fault element. Where the physical element consists only of conduct, intention is the fault element for the relevant physical element.<sup>100</sup> If the physical element constitutes a circumstance or a result, recklessness is the fault element for that physical element.<sup>101</sup> An offence will only be one of strict liability or absolute liability if the offence specifies that consequence.<sup>102</sup>

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<sup>94</sup> The Federal *Criminal Code* was effective from 15 December 2001. Clearly the *Corporations Act* is a relevant Commonwealth State for these purposes.

<sup>95</sup> Section 2.1 of the *Criminal Code*.

<sup>96</sup> Section 5.2 to 5.5 of the *Criminal Code*.

<sup>97</sup> Section 5.6 of the *Criminal Code*.

<sup>98</sup> Contrast the *Financial Services Reform Act* 2001 (restating Chapter 7 of the *Corporations Act*, effective 11 March 2002) that specifically deals with the issues that arise under the *Corporations Act*.

<sup>99</sup> Section 5.1 of the *Criminal Code* provides that a fault element for particular physical element may be intention, knowledge, recklessness or negligence. Section 728(3) does not impose any of these requirements or any other requirement specifying a fault element for the physical elements of the offence in section 728(3) (see section 5.1(2) of the *Criminal Code*).

<sup>100</sup> Section 5.6(1) of the *Criminal Code*.

<sup>101</sup> Section 5.6(2) of the *Criminal Code*.

<sup>102</sup> Section 3.1(2) of the *Criminal Code*.

It would seem that the offence in section 728(3) largely involves physical elements that are characterised as circumstances or results for the purposes of the analysis in the *Criminal Code*.<sup>103</sup>

Intention and recklessness are defined for the purposes of the *Criminal Code* in a similar way to the common law.<sup>104</sup>

The above analysis assumes that the defences to criminal liability set out in section 731 and 733 do not constitute the imposition of a fault element for the offence in section 728(3). It will be seen that the imposition of due diligence defences constitutes an effective negligence standard of conduct in relation to the liability provisions.<sup>105</sup>

However, that is the effect of the operation of the sections rather than the imposition of a standard of culpability in section 728(3) itself. Each of section 731 and 733 provides that “a person does not commit an offence against sub-section 728(3)” if the person can affirmatively establish the existence of the state of affairs described in the sections. The imposition of a separate defence in these terms does not seem to be the imposition of a fault element in the creation of the offence with the meaning of section 5.6 of the *Criminal Code*.

The effect that analysis is that a prosecution would be required to prove a culpability standard of at least recklessness before the accused would be entitled to give evidence of the due diligence defence. This significantly undermines the public policy basis for the criminal liability regime as it moved from the fraud standard of the *Larceny Act 1861* through to the changes in the companies legislation as recommended by the Cohen Committee in 1945. While, as noted above, the result is consistent with the recommendations of the Jenkins committee of the early 1960's and may have a sound policy basis, the result would appear to be entirely inadvertent.

## 2.4 THE MISLEADING OR DECEPTIVE STANDARD

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<sup>103</sup> The three physical elements described above can be characterised in the following way:

- a person offering securities under a disclosure document - this a “conduct” physical element as defined in section 4.1 of the *Criminal Code*, being the offering by a person.
- a misleading or deceptive statement is in the disclosure document - this is a circumstance in which conduct or a result of conduct occurs within the meaning of section 4.1 of the *Criminal Code* because it is a feature of the disclosure document that there is a misstatement.
- the misstatement is materially adverse from the point of view of an investor - this is a result of conduct within the meaning of section 4.1 of the *Criminal Code* because the consequence this statement is the materially adverse effect.

The first physical element therefore imposes an intention fault element while the second and third physical elements impose a recklessness fault element.

<sup>104</sup> Section 5.2 of the *Criminal Code* provides that a person has intention with respect to conduct if he or she means to engage in that conduct, intention with respect to circumstances if he or she believes it exists or will exist and intention with respect to results if he or she means to bring it about or is aware that it will occur in the ordinary course of events. Section 5.4 of the *Criminal Code* provides that a person is reckless with respect to circumstances or results if he or she is aware of the substantial risk that the circumstances exists or will exist and having regard to the circumstances or results it is unjustifiable to take the risk.

<sup>105</sup> See section 4.3 below.

Traditionally the test of liability for prospectus misstatement has been based on a “false or misleading” statement or omission. Both the contract law remedy of rescission and the tort remedy of deceit required proof of a “false” statement. The *1890 Directors Liability Act* had adopted a standard of “untrue” statement which was considered by the courts to be identical to the test of liability at common law used in the tort of deceit.<sup>106</sup> The statutory test was modified in the mid-twentieth century through recommendations of the Cohen committee in England which recommended an expanded “false or misleading” test, without elaborating on what the change was intended to achieve.<sup>107</sup>

CA section 728 changes the standard to one based on “misleading or deceptive” statements. This conforms the language of the *Corporations Act* to the test for misstatement established by section 52 of the *Trade Practices Act*. The question arises as to whether there is any practical distinction between the two standards.

The jurisprudence relating to the historic misstatement standard and the section 52 standard suggests that there is no such practical distinction.

Misrepresentation is a legal concept underlying Australian law that springs from a fundamental equitable principle based on a moral judgment of fairness and good faith where deception is involved.<sup>108</sup> These basic underpinnings is not only the basis of a proper understanding of the misleading and deceptive statement standard, but also the other heads of disclosure liability described in Chapter 5 as well as continuing developments in Australian law such as obligations of good faith.<sup>109</sup>

The historical case law clearly suggests that if a statement is untrue at the time it is made it will be false for purposes of determining falsity.<sup>110</sup> In addition, the case law establishes that falsity

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<sup>106</sup> See *Greenwood v Leather Shod Wheel Company* [1900] 1 Ch 421 at 434 (Lindley MR). The case law clearly demonstrates that the same principles should be applied across various common law and statutory remedies based on falsity - see *R v Kylsant (Lord)* [1932] 1 KB 442 at 448 where Avory J expressed the view that the principles of the common law should be applied to both criminal and civil liability provisions (in relation to the remedy now contained in section 1000 of the *CL*).

<sup>107</sup> Board of Trade “*Report of the Committee on Company Law Amendment*” (1945, Cmnd 6659) at paragraph 42. The Cohen committee was also the genesis of statutory liability for omissions that render misleading a statement included in a prospectus (at paragraph 36). The two additions were seen as complimentary.

An interesting postscript is that the original *1890 Directors Liability Act* had passed the House of Commons on the basis of a test of “untrue or misleading” statements as the relevant test but the words “or misleading” were struck out by the House of Lords - see *Barnett (1934)* at 9. However the distinction intended was unclear.

<sup>108</sup> See the basic analysis from fundamental equitable principles in Chapter 12 and Chapter 13 of *Meagher, Gummow & Lehane (1992)*.

<sup>109</sup> See *Meagher, Gummow & Lehane (1992)* at Chapter 12 and the cases referred to there.

<sup>110</sup> By way of example of the numerous illustrations in the case law of this proposition see the statements in *Flavel v Giorgio* (1990) 2 ACSR 568. Some notable illustrations of outright falsity in the fundraising context include the facts of cases such as *Henderson v Lacon* (1868) 5 LR Eq 249; *Arnison v Smith* (1889) 12 Ch D 348; *Greenwood v Leather Shod Wheel Company* [1900] 1 Ch 421.

can be established by false impression.<sup>111</sup> If a number of statements made in the prospectus give a false impression even though each statement by itself is correct or through omission a statement will be considered false.<sup>112</sup> In that regard, the entire prospectus must be considered, rather than looking at each statement in the prospectus in isolation.<sup>113</sup>

As noted above, the test of falsity was expanded to a “false or misleading” test through recommendations of the Cohen committee without any suggestion as to why the expansion was necessary. The concept of falsity as outlined above had clearly extended to a misleading impression. As such, the addition was probably unnecessary. In addition, the concept of a false statement and an omission overlap to a considerable degree because omissions can create the false impression that will itself be false or misleading.<sup>114</sup>

On the other hand, the Trade Practices jurisprudence suggests that misleading or deceptive conduct is a question of fact to be objectively determined from the surrounding facts and circumstances.<sup>115</sup> The High Court has said in relation to the misleading or deceptive standard that:

“Those words are on any view tautologies. One meaning which the words “mislead” and “deceive” share in common is “to lead into error”. If the words “deceptive” in s52 stood alone, it would be a question to whether it was used in a bad sense, with a connotation of craft or overreaching, but “misleading” carries no such flavour and the use of the word appears to render “deceptive” redundant”.<sup>116</sup>

The case law also suggests that the matter must be considered by reference to the section of the public to which the conduct is addressed including the broad range of people who fall within that

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<sup>111</sup> For case law in the prospectus context establishing falsity through half truth see *Gluckstein v Barnes* (1900) HL (Eq) 240 at 251 (Lord Macnaughten).

For prospectus statements found not to be false because of “puffery” and lack of materiality resulting in the absence of a misleading statement see *McKeon v Boudard Peveril Gear Company Limited* (1896) 74 LT 310.

<sup>112</sup> It was established at a very early point that those responsible for a prospectus had a duty not only to “state everything with strict and scrupulous accuracy ... but to omit no one fact within their knowledge the existence of which to any degree affect the” prospectus as represented - *The New Brunswick & Canada Railway & Land Company v Muggeridge* (1860) 1 DR & SM 363 at 381 - 2. For other clear illustrations of omissions giving rise to liability in the fundraising context see *Peek v Gurney* [1861-7] All ER 116; *Oakes v Turquand* (1867) CL 2 HL 325; *Heymann v European Central Railway Company* (1869) 7 LR Eq 154; *Arkwright v Newbold* (1881) 17 Ch D 301; *Aarons Reef's Limited v Twiss* (1896) AC 273 (Lord Halsbury LC at 281) and *Greenwood v Leather Shod Wheel Co* [1900] 1 Ch 421. For further illustrations see *R v Kysant* (Lord) (1932) 1 KB 442 and *R v M & Ors* (1980) 2 NSWLR 195.

<sup>113</sup> See *Edgington v Fitzmaurice* (1885) 29 Ch D 459 at 467.

<sup>114</sup> For analysis see *Heerey* (1967) at 436.

<sup>115</sup> See *Taco Co of Australia Inc v Taco Bell Pty Ltd* (1982) 42 ALR 177 as an early authority for this proposition (FCA, Deane & Fitzgerald JJ).

<sup>116</sup> *Parkdale Custom Built Furniture Pty Ltd v Puxu Pty Ltd* (1982) 149 CLR 191 at 198 (per Gibbs CJ).

category.<sup>117</sup> Evidence that a person has formed an erroneous conclusion, while not conclusive, will be persuasive evidence. However such evidence is not essential.<sup>118</sup> Conduct will be considered as misleading or deceptive if that is a real and not remote chance or possibility, regardless of whether it is less or more than 50 per cent.<sup>119</sup>

The case law establishes that a statement that is literally true may be misleading or deceptive by way of half true.<sup>120</sup> This correlates to the false impression cases of the historic prospectus case law.

As a consequence of the commonality of the “misleading” standard between the two tests and the observation that the use of the word deceptive is redundant the two bodies of case law can therefore be considered to be basically consistent.<sup>121</sup> The more recent and active Trade Practices jurisprudence can be expected to be strongly influential on Australian securities law cases.

It should be noted that special considerations apply as to whether statements of intention, prediction or opinion can constitute misleading or deceptive conduct. This issue is returned to for detailed analysis in Section 6.3 below.

Fundraising disclosure documents can tend to be lengthy and detailed. In the *Corporations Act* context this may be aggravated by the indeterminacy of the applicable disclosure standard. The question arises as to whether excessive detail may constitute a misleading or deceptive statement, even if the document is literally correct. The difficulty that retail investors would appear to have with Australian disclosure documents as discussed in Section 1.6 illustrates this possible issue.

High Court disapproval of overly complex disclosure can be found in *Peters American Delicacy Co Limited v Heath*.<sup>122</sup> Further recent support for this concern can be found in the *NRMA Case*<sup>123</sup> where the Full Federal Court said:

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<sup>117</sup> Case law suggests that the test is not of whether a “reasonable man” is deceived but a less stringent test of conduct “on a person, not particularly intelligent or well informed, but perhaps of somewhat less than average intelligence and background knowledge, although the test is not the effect on a person who is, for example, quite unusually stupid” - *Annand & Thompson Pty Limited v TPC* (1979) 25 ALR 91 (FCA, Franki J) at 102.

<sup>118</sup> See *Taco Bell Case* above for these principles.

<sup>119</sup> See *Global Sportsman Pty Ltd v Mirror Newspapers Ltd* (1984) 2 FCR 82 at 87; *Tillmans Butcheries Pty Ltd v Australasian Meat Industry Employees’ Union* (1979) 42 FLR 331 at 346.

<sup>120</sup> See *Porter v Audio Visual Promotions Pty Ltd* (1985) ATPR 40-547. For endorsement of the proposition in the securities law context see *Fraser & Anor v NRMA Holdings Ltd & Ors* (1995) 15 ACSR 590 at 599.

<sup>121</sup> To similar effect see *Croker* (1998) at 35.

<sup>122</sup> (1939) 61 CLR 457 (Rich J at 493).

<sup>123</sup> *Fraser & Anor v NRMA Holdings Limited & Ors* (1995) 15 ACSR 590.

“the need to make full and fair disclosure must be tempered by the need to present a document that is intelligible to reasonable members of the class to whom it is directed, and is likely to assist rather than confuse . . . . In complex cases it may be necessary to be selective in the information provided, confining it to that which is realistically useful.”<sup>124</sup>

While that objective is admirable it would seem wrong as a matter of principle to penalise an issuer for over extensive disclosure, particularly if concepts of information efficiency and the information needs of different types of investors, as outlined in Chapter 1, can be considered to be relevant.<sup>125</sup>

## 2.5 MATERIALITY

The trigger for potential liability in relation to misstatements under the companies legislation has traditionally been the concept of materiality. Under the Pre-*CLERP Act Corporations Law* it was only a misstatement that was “material” that gave rise to liability. Prior to the *Corporations Law* an “immaterial” misstatement was a defence to a prosecution. The *1890 Directors Liability Act* only imposed potential civil liability if the misstatement was material. The requirement of materiality flowed from the tort of deceit where the courts had developed the principle that a relevant misstatement must be a material inducement of the loss suffered by an investor.<sup>126</sup>

This regime has been changed with the enactment of the *CLERP Act*. For a criminal prosecution a new test arises, being a misstatement that is:

“materially adverse from the point of view of an investor” (section 728(3)).

The issue that arises is whether there is any distinction between the traditional materiality standard and the materially adverse from an investor’s perspective standard. It would seem that there is no relevant distinction except that liability does not arise for a misstatement where the

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<sup>124</sup> Ibid at 603. For other illustrations of this principal see *Shepherd v Bray* [1906] 2 Ch 235 at 251-2.

In the United States see the “buried facts” doctrine that suggests disclosure will be misleading if a complete understanding can only be obtained by assembling a complete mosaic with great difficulty - see *Kohn v American Metal Climax* 322 F Supp 1331 (EDPa 1970) mod 458 F 2d 255 (3d Cir); *Kennedy v Tallant* 710 F 2d 711 (11th Cir 1983); *Marksman Partners LP v Chantal Pharmaceutical Corp* 927 F Supp 1297 (CCD Cal 1996).

<sup>125</sup> For support of resistance to considering overdisclosure to be misleading see the New Zealand Supreme Court decision of *Power New Zealand Ltd v Mercury Energy Ltd* (1994) 7 NZ,CLC 260,631 at 260,635.

<sup>126</sup> See *Arnison v Smith* (1889) 12 Ch D 348 at 369. See discussion below.

Materiality was also imported by the courts into the requirements of the *1867 Material Contracts Act* as the reference point of disclosure even though materiality was not a component of the disclosure requirements - see *Broome v Speak* [1903] 1 Ch 586.

Similarly, Australian courts have imported materiality into liability under section 52 of the *Trade Practices Act*. See the analysis at Section 5.1.

misleading statement or omission was positive information for investors, for example where the issuer has withheld positive information.

It is worth making the point at the outset that materiality is essentially a non-technical concept.<sup>127</sup> The difficulty that arises with a theoretical assessment of materiality is that the issue will be highly fact specific. In addition, as is discussed in greater detail below, the concept is difficult to grapple with as a result of the difficulty of assessing what motivates an investor to subscribe for securities. A prospectus by its nature is a complex document and the misstatement in question is likely to form only one aspect of the factual matrix that motivated the investment decision. These issues are demonstrated by the case law that involves consideration of materiality.

In the tort of deceit it is, of course, necessary to establish both a fraudulent statement and that the relevant plaintiff has suffered damage as a consequence of that fraudulent misstatement.<sup>128</sup> From the requirement of damage developed a requirement that the fraudulent statement be an “inducing cause” of the damage which was soon equated with the need that the misstatement be “material”.<sup>129</sup>

The requirement that a misstatement be material is best illustrated by *Arnison v Smith*.<sup>130</sup> Lord Halsbury LC made the following comment on the necessity that the misstatement be an inducing cause of loss:<sup>131</sup>

“It is an old expedient, and seldom successful, to cross examine a person who has read a prospectus, and ask him as to each particular statement what influence it had on his mind, and how far it determined him to enter into the contract. This is quite fallacious, it assumes that a person who reads the prospectus and determines to take shares on the face of it can appropriate among the different parts of it the effect produced by the whole. This can rarely be done even at the time, and for a shareholder thus to analyse his first impressions after an interval of several years, so as to say which representation in particular induced him to take shares, is a thing all but impossible. A person reading the prospectus looks at it as a whole, he thinks the undertaking is a fine commercial speculation, he sees good names attached to it, he observes other points which he thinks favourable, and on the whole he forms his conclusions. You cannot weigh the elements

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<sup>127</sup> The New Shorter Oxford English Dictionary (1993, Clarendon Press) defines “material” in this context as:

“serious, important, of consequence ... pertinent, relevant, essential to”.

<sup>128</sup> *Pasley v Freeman* (1789) 2 Sm LC 66; 3 TR 51 “Fraud without damage, or damage without fraud, gives no cause of action, but where these two concur an action lies”.

<sup>129</sup> See *Smith v Chadwick and Ors* (1883) 9 AC 187 at 190 (Earl of Selbourne LC); *Arnison v Smith* (1889) 41 Ch D 348; *Derry v Peek* (1889) 14 AC 337.

<sup>130</sup> *Arnison v Smith* (1889) 41 Ch D 348.

<sup>131</sup> The prospectus had stated £200,000 of issued shares had been “subscribed” when in fact the shares had been issued to a contractor for the provision of services to the issuer - see *Ibid* at 355-7 (Kekewich J trial judge).

by ounces... if a court sees on the face of the statement *that it is of such a nature as would induce a person to enter into the contract, or would tend to induce him to do so, or that it would be part of the inducement to enter into the contract*, the inference is, if he entered into the contract, that he acted on the inducement so held out, unless it is shown that he knew the facts, or that he avowedly did not rely on the statement whether he knew the facts or not.”<sup>132</sup>

The court recognised that it is a difficult practical matter to determine how an investment decision is made based on a prospectus. Attempts by the defendant to obfuscate that issue through argument that the investor had not been influenced by the statement were rejected. Instead an approach is endorsed where the court applies its view of the materiality of the statement, with reliance then being presumed unless the defendant can prove there was not reliance. In other words, an objective standard of materiality is introduced (in the words of Lord Halsbury whether it would induce, would tend to induce or would be part of inducement of an investor).

The difficulty with the deceit cases is that issues of reliance are also fundamental to a finding of damages. As such, many of the deceit cases tend to confuse the separate issues of materiality and reliance. As noted by Lord Halsbury in *Arnison v Smith* the materiality requirement is essentially a convenient filtering device for the court to establish a requirement beyond which a defendant should have a case to answer. Once that threshold is established by the investor, reliance can be presumed in the absence of proof by the defendant that the misstatement was more than an inducing cause for loss by the particular plaintiff.

In addition to the deceit cases the concept of materiality became an important element in establishing liability under the *1867 Material Contracts Act*. That legislation did not by its terms refer to the need for a misstatement to be material - liability arose under the legislation if a contract required to be disclosed by the legislation was omitted from a prospectus. However, the case law quickly established that, as for the tort of deceit, no liability in damages would arise unless it could be established that the relevant omission was an inducing cause of damage suffered.<sup>133</sup>

This requirement is illustrated by the decision of *Cackett v Keswick*.<sup>134</sup> In that case both the trial judge and the Court of Appeal held that liability under the *1867 Material Contracts Act* for the failure to disclose a contract would only arise if the non-disclosure was “material”. The

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<sup>132</sup> Ibid at 369. For other illustrations of this principal see *Shepherd v Bray* [1906] 2 Ch 235 at 251 - 2.

<sup>133</sup> Ultimately resolved in *Nash v Calthorpe* [1905] 2 Ch 237 and *Macleay v Tait* [1906] AC 24. See also *Twycross v Grant & Anor* (1877) 2 Ch CPD 469 at 497 (Bramwell J) and 528-9 (Cockburn J). See the analysis in *Heerey (1967)* at 432-5.

<sup>134</sup> *Cackett v Keswick* [1902] 2 Ch 456.

particular issue that must be grappled with in all cases under this legislation is that the misstatement involves an omission - a contract that is not disclosed as required by the legislation. As such, proof that the omission was an inducing cause of an investment decision is confusing because in no case will the relevant plaintiff have known of the contract in question. The trial judge dealt with the problem by stating:

“The test must be, is the omission material? And if the court sees that the fact omitted is of such a nature *that it might reasonably deter, or tend to deter, the ordinary investor from entering into the contract, that is sufficient*. It is in great measure and if a material fact is omitted from a statement put forward to induce a person to enter into a contract, and he does enter into the contract on the face of that statement, it is a fair inference that he would not have contracted if he had known of the fact, and that in this sense the omission induced the contract.”<sup>135</sup>

That approach was endorsed by the Court of Appeal. In that regard Stirling LJ said:

“Now the question is, *would the knowledge of such a contract affect the mind of a reasonable investor thinking of taking shares in this company?*”<sup>136</sup>

Clearly these cases demonstrate the objective criteria that surround the concept of materiality. Since the development of that body of case law issues of materiality have become a feature not only of the statutory remedies for prospectus misstatement but also a variety of other securities law disclosure issues, such as disclosure of information in shareholder meeting documents and disclosure of information in takeover documents. There is a body of case law that has developed in these areas that largely reinforce the analysis outlined above.<sup>137</sup>

An interesting contemporary assessment of materiality was contained in the 1990 New Zealand decision of *R v Rada Corporation Limited*.<sup>138</sup> The relevant criminal liability provision of New Zealand law provided a defence for an “immaterial” matter.<sup>139</sup>

In addressing the issue of materiality the judge referred to the quote set out above from *Arnison v Smith*. Extensive evidence was produced on the question of the materiality of the relevant

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<sup>135</sup> Ibid at 464 (Farwell J). See also *Nash v Calthorpe* [1905] 2 Ch 237 at 251 (Romer LJ); In *Re Wimbledon Olympia, Limited* [1910] 1 Ch 603.

<sup>136</sup> Ibid at 477.

<sup>137</sup> See for example *R v McKinnon* [1959] 1 QB 150; *Re Rossfield Group Operations* (1981) 5 ACLR 237; *Re Pine Vale Investments Ltd* (1988) 13 ACLR 757; *ICAL Ltd v County Natwest Securities Australia Ltd* (1988) 13 ACLR 129

<sup>138</sup> *R v Rada Corporation Ltd & Ors* (1990) 5 NZCLC 96,413. The case involved a criminal prosecution against a company and certain directors in relation to a statement contained in a prospectus to the effect the defendant company would subscribe for approximately 50% of the issued capital of the issuer. It was alleged that the prospectus contained an omission in that the defendant company did not have cash or any firm arrangement to find the subscription moneys at the time the prospectus was released - Ibid at 66,641. The shares in question were ultimately subscribed for in a manner that had not been contemplated at the time the prospectus was signed. The manner of subscription was through an apparently suspect transaction described as a “round robin” by the trial judge where the issuer would not appear to have received the economic benefit of the subscription moneys - see Ibid at 66,634.

<sup>139</sup> Therefore reflecting the approach in Australia prior to the *Corporations Law* where immateriality was a defence to be established by the accused.

statement by both the prosecution and the defence.<sup>140</sup> Ultimately the trial judge found that the omission of certain information was not material because the non-disclosure of the information in question could not have caused investors loss.<sup>141</sup> The case illustrates the nexus between the requirements of materiality and the need that damages result from the misstatement in question, even where a prosecution is involved.

The defence further led evidence based on the efficient market hypothesis so as to argue that the omission was not material. The fact that the share price of the security did not move when the information was subsequently disclosed was said to establish the immateriality of that information. The trial judge noted the relevance of the issue but made no finding on the point.<sup>142</sup> It is a pity that the efficient market hypothesis point was not specifically addressed on as it is the only example in the Commonwealth jurisprudence on fundraising where the issue has been argued.

It is the United States jurisprudence that gives the most authoritative case law analysis on the test of materiality as it should apply to securities transactions. As with the Commonwealth precedent, United States courts have opted for a reasonable investor test for materiality in the securities law context.<sup>143</sup> The debate in the United States over the last decades has related to the evidentiary threshold that needs to be established before the court will presume an impact on the investment decision of an investor.

In the 1960s and 1970s two divergent approaches had arisen as to the appropriate formulation of the materiality requirement. On the first approach, materiality would be established if a

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<sup>140</sup> Prosecution witnesses stressed that investor confidence in the float was enhanced through the implication that the defendant company could afford its investment and that the issuer would have the benefit of those funds following the float. On the other hand the defence called experts who gave evidence that the defendant company had, at the relevant time, the financial capacity to raise the funds.

<sup>141</sup> "The omission was immaterial because ... RCL [the defendant] both had the \$50 million in readily realisable assets or could have borrowed \$50 million from a variety of sources. Investors reading the prospectus would have assumed that RCL would be finding the PRL [the issuer] share money either from its own resources or from borrowings ... the fact that RCL eventually subscribed for its shares in an unreal way cannot be material to the information known to the directors on 14 October 1986 [the date of the prospectus] ... Because of the public interest in this case, it should be noted that no investor appears to have incurred any loss because of any lack of information in the prospectus, except loss, if any, which may be attributed to PRL's not having the unrestricted use of \$50 million for three months ... the subsequent ill fortune which beset RCL and PRL after their crash, cannot be ascribed to the money-go-round transaction or any alleged non-disclosure in the PRL prospectus." Ibid at 66,646.

<sup>142</sup> "Another witness, Mr Laurenson, a market analyst called for the defence, supported the "efficient markets" theory as did Professor Emanuel. This theory was rejected by Mr Gaynor. In short, under this theory the market price for shares fully and instantaneously reflects all available information. Share prices provide accurate signals for resource allocation. Because there was no drop in RCL share prices following the flotation of PRL, that fact shows that the admitted statements were immaterial. Mr Gaynor did not subscribe to this theory. I find it unnecessary to express my views on the theory in light of the decision I now reach." [The trial judge then went on to conclude the matter was immaterial on more traditional analysis.] Ibid at 66,646.

United States courts have referred to the existence of price movements following disclosure that is alleged to be material as strong evidence in support of a materiality finding - see *Elkind v Liggett & Myers, Inc* 635 F 2d 156 (2D Cir 1980) at 166.

<sup>143</sup> It is not enough that an investor may find information "interesting", the information must be sufficient to influence the investment decision - see *Milton v Van Dorn Company* 961 F 2d 965 (1st Cir 1992) at 969.

reasonable investor “might” consider the matter in question important to the investment decision.<sup>144</sup> On the other approach it was considered necessary to establish a higher evidentiary threshold so that the reasonable investor “would” consider the matter in question important to the investment decision.

Under both tests the question is to be determined objectively. The question was ultimately resolved in favour of the higher evidentiary standard by the United States Supreme Court in 1976 in *TSC Industries, Inc. v Northway, Inc*<sup>145</sup>. The Supreme Court said a matter will be material:

“if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to [vote] ... It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his [vote]. What the standard does contemplate is the showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available”.<sup>146</sup>

The *TSC Industries case* involved an omission from a proxy statement. However, it is quite clear that the principles adopted by the Supreme Court have application across the securities law context generally.

A more recent affirmation of the *TSC* approach is contained in the 1988 Supreme Court decision of *Basic Inc v Levinson*,<sup>147</sup> a case involving liability under Rule 10b-5 in relation to alleged disclosure obligations of a listed company. The Supreme Court again confirmed the standard of the *TSC Industries* case as the appropriate securities law test of materiality<sup>144A</sup>. The case law has been specifically applied by lower courts to the section 11 context.<sup>148</sup>

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<sup>144</sup> Examples of such a judicial approach are seen in the *Feit Case* (at 570-1). This was the orthodox approach prior to the *TSC* case.

<sup>145</sup> *TSC Industries, Inc et al v Northway, Inc* 426 US 438 (1976).

<sup>146</sup> *Ibid* at 449. It was noted that the issue of materiality is a mixed question of facts and law involving the application of a legal standard to a set of facts (at 450).

Importantly, from the theoretical perspective, the Supreme Court noted that the setting of the materiality threshold too low may accomplish more harm than good by burying shareholders in an avalanche of trivial information (at 448-9).

<sup>147</sup> *Basic Inc v Levinson* 485 US 224 (1988). The issue was whether preliminary merger negotiations required disclosure where the company had previously denied the existence of such negotiations.

<sup>144A</sup> The standard was again endorsed in *Virginia Bankshares v Sandberg* 501 US 1083 (1991), a case concerning proxy solicitation.

<sup>148</sup> See *Ross, et al v Warner, et al* [1981] Fed Sec L R (CCH) 97,735 (SDNY) at 98,860-1; *Ahearn et al v Gausson, et al* [1985-6] Fed Sec L R (CCH) 92,332 (DO); *Kronfeld v TransWorld Airlines, Inc, et al* [1987] Fed Sec L R (CCH) 93,510; *In re The Ultimate Corp Securities Litigation* [1989] Fed Sec L R (CCH) 94,523; *In re Donald J Trump Casino Securities Litigation - Taj Mahal Litigation* 7 F 3d 357 (3d Cir 1993) at 369.

The United States material should therefore be seen as influential in confirming the objective criteria of a reasonable investor that should be applied as well as giving guidance to courts as to the way in which they should approach the task of identifying materiality.

The old English case law is much less precise on the evidentiary point that is reflected in the United States jurisprudence. The Court of Appeal decision in *Cackett v Keswick* cited above<sup>149</sup> could be used as authority for a higher evidentiary standard (“would the knowledge ..... affect”). On the other hand the lower court decision cited above<sup>150</sup> could be used as authority for a relaxed evidentiary standard (“might reasonably deter”). Analysis of this case law however suggests that the judges saw no great significance in the semantic choice of words used.

Clearly there is scope for this debate to become an issue in the Australian context. The United States approach to materiality received some recent Australian comment in the takeover case of *Pancontinental Mining Ltd v Goldfields Ltd*.<sup>151</sup>

Tamberlin J reaffirmed that materiality involves a fact specific inquiry:

“Materiality is a question for the court although evidence may be tendered to enable a court to understand why certain matters are material or why they are not: *ICAL Limited v County NatWest Securities Aust Limited* (1988) 13 ACLR 129 at 137. It is a question of mixed fact and law and it depends on the facts and is to be determined on a case by case basis.”<sup>152</sup>

In addition, the judge said the object of materiality requirements are as follows:

“The object is to put shareholders in possession of the information required to enable them to make an informed and critical assessment of the offer and an informed decision whether to accept it. Information is material which *could* affect the shareholders assessment of whether the offeror is likely to improve its offer, the prospects of a competing offer, and the prospects of the shares if retained....*cf* the standard of materiality applied by the US Supreme Court, namely that an omitted fact is material if there is a substantial likelihood that a reasonable investor *would* consider it significant in deciding how to vote or whether the vote would have a significant propensity to affect the voting process.”<sup>153</sup>

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<sup>149</sup> See footnote 127. To similar effect see *Smith v Chadwick & Ors* (1883) 9 AC 187.

<sup>150</sup> See footnote 144. To similar effect see *Arnison v Smith* at footnote 123; *Broome v Speak* [1903] 1 Ch 586 at 627 (Romer LJ) and 629 (Cozens - Hardy CJ) (appeal dismissed *Shepherd & Anor v Broome* [1904] AC 342 but the issue of materiality was not referred to by the House of Lords).

<sup>151</sup> *Pancontinental Mining Ltd v Goldfields Ltd* (1995) 16 ACSR 463 (FCA) where Tamberlin J set out certain general guidelines derived from previous court decisions in the area of takeovers.

<sup>152</sup> *Ibid* at 466.

<sup>153</sup> *Ibid* at 467 citing *TSC Industries Inc v Northway Inc* and *Basic Inc v Levinson*.

This sentiment has been echoed in subsequent case law, but without any significant more detailed analysis on the evidentiary point.<sup>154</sup> In New Zealand the Court of Appeal in *Coleman v Myers*<sup>155</sup> adopted a similar approach<sup>156</sup>.

In assessing materiality issues it is also worthwhile to note the impact of Australian Accounting Standards on the practices adopted in preparing Australian prospectuses.

Australian Accounting Standard 5 and Australian Accounting Standards Board 1031 are frequently used as the appropriate filtering device in determining materiality. AAS 5<sup>157</sup> and AASB 1031<sup>158</sup> adopt a purposive approach to the issue of materiality. The standard says:

“It is not possible to give a definition of “material” which would cover all circumstances. In general, however, an item of information is material if its omission, non-disclosure or misstatement would cause financial statements to mislead users when making evaluations or decisions.....It follows that the test of materiality involves consideration of the users, or likely users, of financial statements, the information needs of those users, and, therefore, of the objectives of financial reporting.”<sup>159</sup>

As to the approach to assessing materiality in a particular case, the standard stresses the fact specific nature of the exercise by reference to the use to which the information is to be put:

“In deciding whether an item is material, its nature and its amount usually need to be evaluated together. However, in particular circumstances, either the nature or the amount could be the determining factor.....consideration of qualitative factors may oppose more rigorous requirements on the interpretation of materiality than those reflected by any quantitative guidelines.”<sup>160</sup>

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<sup>154</sup> See *Cultus Petroleum NL v OMV Australia Pty Ltd* (1999) 32 ACSR 1 (SCNSW, Santow J) at 12; *AAPT Ltd v Cable & Wireless Optus Ltd & Ors* (1999) 32 ACSR 219 (SCNSW, Austin J) at 227; *Acacia Resources Ltd v Delta Gold NL (Nos 1 & 2)* (1999) 33 ACSR 144 (SC Vic, Warren J) at 152-4.

<sup>155</sup> *Coleman & Ors v Myers & Ors* [1977] 2 NZLR 225 (Woodhouse, Cooke & Casey JJ).

<sup>156</sup> Per Cooke J at 333-4. *TSC Industries v Northway* was specifically endorsed. Cooke J noted an evidentiary debate between “might” and “would” arising from the decision on appeal and suggested that if forced to choose he would select an evidentiary burden somewhere between the two alternatives. However he was content to accept the evidentiary formulation of *TSC Industries v Northway* as the appropriate standard (see also Casey J at 371).

<sup>157</sup> First issued August 1974; reissued November 1986.

<sup>158</sup> Issued September 1995.

<sup>159</sup> *Ibid*, paragraphs 6 and 7.

<sup>160</sup> *Ibid* paragraphs 8 and 9.

The standard proceeds to impose quantitative guidelines for testing the financial statement disclosures based on a presumption of materiality where 10% or more of a reference point is exceeded and a presumption of immateriality where less than 5% is involved.<sup>161</sup>

The accounting standards therefore clearly warn its users that while a qualitative assessment is a useful benchmark it is not of paramount consideration in assessing the materiality of a financial disclosure.<sup>162</sup>

The difficulty with a simple percentage approach to materiality is that a reasonable investor may place significance on a piece of information that is not susceptible to translation in simple financial terms, as is recognised in the accounting standards. The elastic standard of materiality adopted in the case law described above provides a more useful basis for testing appropriate disclosure in the prospectus context and should be favoured over a simplistic percentage approach.

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<sup>161</sup> “Guidelines which attempt to establish quantitative thresholds for determining materiality and amount must, of necessity, be drawn at arbitrary levels. Whilst recognising this, the following percentage limits are proposed as useful benchmarks in considering the materiality of the amount....

- (a) an amount which is equal to or greater than 10 per cent of the appropriate base amount, ought to be presumed to be material unless there is evidence to the contrary;
- (b) an amount which is equal to or less than five per cent of the appropriate base amount, ought to be presumed to be immaterial unless there is evidence, or convincing argument, to the contrary; and
- (c) no presumption ought to be made as to materiality of an amount which lies between five per cent and ten per cent of the appropriate base amount prior to consideration of the nature of the item.”

Ibid at paragraph 12.

<sup>162</sup> The Australian materiality standards are consistent with the approach adopted by accounting standards in other leading jurisdictions - for example, in the United States the same principles apply - FASB Statement of Financial Accounting Concepts No 2 “*Qualitative Characteristics of Accounting Information*”.

## CHAPTER 3

### THE CIVIL LIABILITY REGIME

#### 3.1 BACKGROUND TO CIVIL LIABILITY REGIME

By virtue of *CA* section 729, any contravention of the prohibitions on misstatement or on updating a disclosure document contained in *CA* section 728(1) gives rise to potential civil liability for any person listed in the table included in the section.

The persons who face potential liability are:

- the person making the offer, for all statements in the disclosure document;
- directors and named proposed directors, for all statements in the disclosure document;
- underwriters (but not sub-underwriters), for all statements in the disclosure document;
- named persons who make a statement in the disclosure document or who make a statement on which a statement in the disclosure document is based, for that statement only;
- a person who contravenes or is involved in the contravention,<sup>1</sup> for that contravention.

The persons who may seek compensation is a person who “suffers loss or damage” from a prospectus misstatement. The compensation recoverable is the “amount of the loss or damage”. The limitation period for the cause of action is six years from when the cause of action “arose”.

Certain defences to that potential civil liability are set out in Part 6D.3 (see Chapter 4).

The immediate predecessor to section 729 (*CL* section 1006) was similarly framed to section 729, although the list of persons specified as facing potential primary liability was longer.

However, *CL* section 1006 was quite differently formulated to the predecessor civil liability provision to the *Corporations Law*, section 107 of the *Companies Code* 1981. Section 107 of the *Companies Code* had remained substantially unchanged in each Australian state since their initial adoption of the civil remedy based on the *1890 Directors Liability Act*.

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<sup>1</sup> As defined in section 79 of the Corporations Act.

Section 107 of the *Companies Code* 1981 had provided that specified persons (being directors, proposed directors, promoters and persons authorising or causing the issue of the prospectus) would be liable to pay compensation to all persons who subscribe for or purchase securities on the faith of a prospectus for any loss or damage sustained by reason of any misstatement.

### SIRC Report

A key recommendation of the *SIRC Report* was that section 107 of the Companies Code was not adequate<sup>2</sup> and should be restated with the intended result that:

“The persons to whom liability attaches will be readily identifiable and the standards expected of them made clear.”<sup>3</sup>

The key deficiencies with section 107 identified in the *SIRC Report* were the ambiguity of the term “authorise or cause the issue”, lack of clarity as to whether damages would be available for persons who purchase securities in the secondary market and the reliance requirement of section 107<sup>4</sup>.

On the basis of these perceived deficiencies the *SIRC Report* recommended reform in six key areas:

- that underwriters and brokers should be deemed to be persons who authorise the issue of a prospectus;<sup>5</sup>

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<sup>2</sup> See paragraph 2.2.4 of *SIRC Report*.

<sup>3</sup> *SIRC Report* at paragraph 6.1.

<sup>4</sup> *SIRC Report* at paragraph 6.2:

“Section 107 as it stands poses a number of interpretative problems. First, liability is attached to directors, named prospective directors, promoters and persons who “authorised or caused the issue of the prospectus”.

Secondly, it is not at all clear whether compensation is payable only to persons who accept the offer contained in the prospectus, or to purchasers and sub-purchasers in the secondary market. The legislation specifies “persons who subscribe for or purchase” the shares, but there is a prevailing view that this language refers to the possibility that the prospectus could offer shares for subscription *or* purchase. On the other hand, in that case section 104 deems the purchasers to be subscribers. Again, nobody really knows.

In addition to these interpretative problems, the Committee found the basic liability provisions unsatisfactory in substance on one ground.

A plaintiff is eligible for compensation if he or she subscribed for or purchased shares on the faith of the prospectus, sustained loss or damage, and that loss or damage was sustained by reason of an untrue statement in the prospectus, or non-disclosure of a matter which the defendant knew about and which he knew to be material.

The difficulty with this lies in the second element described. A prospectus is a document which is produced expressly for the purpose of inducing persons to invest. Why should they then have to prove a subjective matter such as reliance on that document? It appears to the Committee that the provision is in this respect too onerous on the plaintiff.”

<sup>5</sup> *SIRC Report* at paragraph 6.3.1.

- that compensation be available to subsequent purchasers of securities as well as initial subscribers;<sup>6</sup>
- that a subscriber should be presumed to invest on the faith of the prospectus and, in the case of secondary purchasers, a presumption of reliance within six months of the issue of the prospectus;<sup>7</sup>
- that the plaintiff must prove the existence of a false or misleading statement or omission but, having done so, the defendant should then have the burden of establishing lack of materiality or no harm to the purchaser.<sup>8</sup>

It is interesting that so few of these issues were actually addressed with the enactment of the *Corporations Law* or are now addressed under *CA* section 729.

### Original Corporations Law

Civil liability was implemented prior to the enactment of the *CLERP Act* by subdivision B of Part 7.11 Division 4 of the *Corporations Law* and the conjunction of sections 996, 1005(1) and 1006(2). The legislative scheme was certainly not a picture of clarity, as the following description illustrates. The initial legislative regime of civil liability is a clear example of the drafting difficulties associated with the *Corporations Law* and was reflective of a failure to identify appropriate theoretical policy underpinnings in preparing the legislation. This stood in clear contrast to the clearly expressed policy objectives presented by the *SIRC Report*.

Section 1005(1) of the *Corporations Law* provided for a remedy in damages for any contravention of Part 7.11 or Part 7.12 of the *Corporations Law* - those provisions being broader than liability for prospectus misstatement. The legislation copied section 82 of the Trade Practices Act.<sup>9</sup> The section permitted recovery against any person “engaged in” the relevant contravention or any person “involved in” the contravention.

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<sup>6</sup> “There is no difference in substance between one person who receives an allocation of shares in a float and another who buys them in the market shortly after listing. Depending on the price they come on at, one or other is taking more risk, that is all.”

<sup>7</sup> SIRC Report at paragraph 6.3.3.

<sup>8</sup> SIRC Report at paragraph 6.3.4.

<sup>9</sup> Paragraph 2989 of Explanatory Memorandum to the *Corporations Bill* 1988 (AGPS) states:

“CL. 1005 is a general damages clause. While damages were available under the previous legislation this provision adopts a new format (based on TPA s.82). The clause ... is subject to the specific *CL* provisions found in cls 1006 to 1015.”

In the prospectus context, the primary sections of Part 7.11 or Part 7.12 that were likely to be contravened as a consequence of a prospectus misstatement were the criminal liability provision of section 996 in Part 7.11<sup>10</sup> and the disclosure requirements of section 1022 in Part 7.12.

However, any contravention of a provision of those parts gave rise to potential civil liability under section 1005.<sup>11</sup>

Section 1006(2) deemed a long list of specified persons to be “involved in” a contravention for the purposes of section 1005(1).<sup>12</sup> The appropriateness of that listing of persons is revisited below. The reason given for expanding the persons with primary responsibility under section 1005 from that set out in the preceding legislation was for the purposes of “ensuring prospectus integrity”.<sup>13</sup>

Section 1006(1) provided that the section only applied to conduct being the issue of a prospectus in which there was a material statement that was false or misleading or from which there was a material omission. As such, the terms of section 996 were repeated as the pre-conditions to the persons listed in section 1006(2) having liability. A breach of Part 7.11 or Part 7.12 that did not involve a prospectus misstatement would therefore not give rise to liability for any person listed in section 1006(2) unless that person engaged in the contravention or was considered to be involved in the contravention for reasons other than being named in the list in section 1006(2).

In addition to potential civil liability arising from a person being engaged in a contravention, a person could face liability for being “involved in” the contravention on the general terms set out in the *Corporations Law*.

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<sup>10</sup> Section 10141H of the *Corporations Act* (from 11 March 2002, before then section 995) is also, of course, directly relevant. That civil remedy is the subject of separate detailed analysis in Chapter 5.

<sup>11</sup> However for many procedural requirements presumably there would be little likelihood of loss being suffered by reason of the contravention.

<sup>12</sup> Those persons were:

- the corporation;
- directors at the time of issue;
- proposed directors who have agreed to be named;
- a promoter;
- an expert who has a statement in the prospectus;
- a named stockbroker, sharebroker or underwriter;
- a named auditor, banker or solicitor of the corporation or in relation to the offer;
- a named person performing a function in a professional, advisory or other capacity for the corporation or in relation to the offer.

<sup>13</sup> Paragraph 2996 of Explanatory Memorandum to the *Corporations Bill* 1988 (AGPS) states:

“By expanding the range of persons who may be held liable for ‘defective’ prospectuses it is sought to provide another means in the Bill of ensuring prospectus integrity. The Bill aims to make all persons involved in the preparation of a prospectus responsible for the prospectus. At the same time it can be noted that the provision does not act indiscriminately or unfairly. Each of the persons who may be liable under cl. 1005 is provided with a defence and in general will only be liable if they have not exercised due diligence.”

Section 79 of the *Corporations Act* defines “involvement in the contravention” in the following terms:

- aiding, abetting, counselling or procuring the contravention;
- inducing whether by threats or promises or otherwise the contravention;
- in any way directly or indirectly knowingly being concerned in or party to the contravention;
- conspiring with others to effect the contravention.

It will be noted that this definition is similar to accessory liability in section 5 of the Commonwealth *Crimes Act* 1914 as referred to in Section 2.1 above.

### CLERP Act Reforms

The primary initiative of the *Simplification Task Force* was to propose a narrowing of the list of persons facing deemed liability as well as a significant simplification in the operation of the applicable defences.<sup>14</sup> That proposal flowed through into the *CLERP Fundraising Paper*. The *CLERP Fundraising Paper* asserted that:<sup>15</sup>

- The *Corporations Law* imposition of wide responsibilities on a large number of people went beyond what was appropriate to ensure market integrity.
- In some cases, liability was imposed on people outside their proper responsibility.

It was suggested those matters resulted in higher compliance costs without commensurate benefits.<sup>16</sup>

The Explanatory Memorandum to the *CLERP Bill* made it clear that the intent of the legislation was to “clarify” the people who could be liable for a disclosure document.<sup>17</sup> The persons to face

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<sup>14</sup> Proposals 25 and 26, Page 16 of *Simplification Task Force Paper on Fundraising*.

<sup>15</sup> *CLERP Fundraising Paper* at 40.

<sup>16</sup> While the sentiment of this statement seems correct, as will be discussed in Chapter 9, the assertion of higher compliance costs was made without any objective evidence as to its truth or otherwise.

One view is that compliance costs were not higher but that certain of the named advisors assumed a potential risk of liability that was not fair in the circumstances.

<sup>17</sup> Paragraph 8.30 of Explanatory Memorandum.

liability should be the issuer of the document, directors, proposed directors and underwriters. Other persons should only be liable for statements for which they are responsible for.

The key distinction between the persons listed in the previous section 1006(2) and the table in section 729 is the expanded application in the previous section 1006(2) to a person who is a:

- promoter;
- sharebroker or subunderwriter named with their consent;
- auditor, banker or solicitor named with their consent;
- person performing a function in a professional, advisory or other capacity named with their consent.

The imposition of primary liability on persons other than the issuer finds its policy support in the theory that such persons have an important role as “gatekeepers” to ensure the accuracy of disclosures made in offer documents.<sup>18</sup> At one level, gatekeeper liability is based on the proposition that the imposition of liability on such persons acts to ensure the issuer complies with its legal obligations. This is particularly the case with persons such as underwriters, lawyers and accountants who are repeat players in the capital raising process and therefore have more to lose through the imposition of potential liability in a transaction compared to the position of the issuer and corporate insiders who may be much more prepared to take a one-off risk in relation to a particular disclosure matter.<sup>19</sup>

There is also a second policy basis for imposing gatekeeper liability that is based on the reputation issues surrounding the use of particular intermediaries and advisors.<sup>20</sup> If that person has a strong reputation their association with the offering adds credibility or a certification of quality to the offering. It is considered appropriate to impose potential liability on such persons so as to provide an assurance of the quality that is implied by the participation of the reputational intermediary.<sup>21</sup> A gatekeeper liability regime imposes a positive duty on private gatekeepers to prevent misconduct arising by withholding support where misconduct is discovered.<sup>22</sup>

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<sup>18</sup> The leading analysis of this theory is *Kraakman (1986)*. See also *Choi (1998)*.

<sup>19</sup> Described as a classic gatekeeper liability strategy - see *Kraakman (1986)* at 82-3.

<sup>20</sup> See *Choi 1998* at 917-8.

<sup>21</sup> It was noted in chapter 1 that principles of information efficiency are assisted through reducing verification costs with the mandatory disclosure of material information - see text at footnote 235 of Chapter 1. In that regard *Gilson & Kraakman (1984)* at 621 stated the investment banker represents to the market that it has evaluated the issuer's product and is prepared to stake its reputation on that value.

It has been suggested that the appropriate theoretical basis for the imposition of liability on gatekeepers should depend upon “the persons probable power to influence the content of the registration statement and to the extent that the purchaser would likely rely upon that persons authority.”<sup>23</sup> Gatekeeper liability should be predicated on the person possessing privileged information that cannot be accessed by outside regulators.<sup>24</sup> Further, the gatekeeper should be in a position where it is appropriate that a duty to monitor is imposed on that person<sup>25</sup> and the gatekeeper has the ability to influence decision making.<sup>26</sup>

Clearly the imposition of joint liability in this way is sound as a matter of policy.<sup>27</sup> The question is how deeply should the liability net extend from the issuer and its directors and the clarity with which liability is imposed on those categories of person.

That policy issue is analysed for corporate insiders, underwriters and advisors in the Chapters that follow.

Beyond the general policy debate based on gatekeeper liability, the *Corporations Law* involved issues of drafting ambiguity as applied to persons involved in the capital raising process. An example of that ambiguity was the imposition of potential liability on a “promoter” under the *Corporations Law*. A consideration of the statutory regime and case law applicable to the promoter confirms that the deletion of references to promoters was desirable from the perspective of clarifying the operation of the liability provisions. The term “promoter” was previously defined in the *CL* as a promoter of a body who is party to the preparation of the prospectus or any part.<sup>28</sup> The difficulty with the concept was its ambiguity in relation to those involved in modern prospectus preparation.

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<sup>22</sup> *Kraakman (1986)* at 54.

<sup>23</sup> See *Folk 1 (1969)* at 12. *Kraakman (1986)* at 93-4 argues that the reasons for the imposition of gatekeeper duties are high when the possibility of quality differences is not externally available and where independent verification by purchase would be expensive.

<sup>24</sup> See *Kraakman (1984)* at 868.

<sup>25</sup> See *Kraakman (1984)* at 889.

<sup>26</sup> See *Kraakman (1984)* at 890.

<sup>27</sup> On the other hand, *Choi (1998)* argues that when considerations associated with the cost of regulation are introduced, gatekeeper liability may be too heavy handed a regulatory response (at 918 and 939). *Choi (1998)* instead argues for there to be market-based incentives for intermediaries to act as certifiers rather than regulatory imposition of gatekeeper liability (the analogy is drawn to the role of ratings agencies as reputational intermediaries which is not legislatively mandated and does not base itself on gatekeeper liability theories for the ratings agencies).

<sup>28</sup> *CL* section 9 definition.

The role of the promoter had featured strongly in the case law of the 19th century where many litigated prospectuses involved a shadowy scoundrel who would acquire assets and then resell them at an inflated price to an unsuspecting public through an initial public offering. Non-disclosure of this type of arrangement was the genesis of the first of the prospectus liability legislation, the *1867 Material Contracts Act*.

A judicial response to this type of activity was for the common law to impose a fiduciary duty on the “promoter”, irrespective of whether or not the promoter was also a director.<sup>29</sup> The fiduciary duty is owed to the company. The result is that where assets are sold by a promoter to a company formed to acquire those assets the promoter can only resell the assets at a profit if there is full disclosure to the company.<sup>30</sup> If disclosure is to be made only to directors and not shareholders the promoter must show that the board is independent.<sup>31</sup> If that test of independence is not satisfied disclosure to all shareholders is necessary.<sup>32</sup> The disclosure required is the essential terms and conditions of the arrangement as well as the amount of profit involved. That duty of promoters continues to subsist outside the operation of Chapter 6D of the *Corporations Act*.

Against that background it is not surprising that early formulations of legislative liability for prospectuses imposed liability on the promoter as a category of responsible person.<sup>33</sup>

However, the application of statutory disclosure liability to the promoter has always sat uncomfortably with the concept of prospectus disclosure liability. The case law defining the common law of fiduciary duty of the promoter is reasonably well settled.<sup>34</sup> However, the

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<sup>29</sup> See in the Australian context the examples of *The Wheel Ellen Gold Mining Company No Liability v Read* (1908) 7 CLR 34; *Para Wirra Gold & Bismuth Mining Syndicate NL & Anor v Mather & Ors* (1934) 51 CLR 582.

<sup>30</sup> See for example *Bagnall v Carlton* (1877) 6 Ch D 371; *Erlanger v New Sombrero Phosphate Co* (1878) 3 AC 1218; *Emma Silver Mining Company v Grant* (1879) 11 Ch D 918; *In re Cape Breton Company* (1885) 29 Ch D 7695; *Lagunas Nitrate Company v Lagunas Syndicate* (1899) 2 Ch 392; *Gluckstein v Barnes* (1900) HL (Eq) 240; *Omnium Electric Palaces v Baines* (1914) 1 Ch 332.

<sup>31</sup> *Gluckstein v Barnes* (1900) AC 240; *In Re Jubilee Cotton Mills, Limited* (1922) 1 Ch 100, (1923) 1 Ch 1 and [1924] AC 958.

<sup>32</sup> *Salomon v Salomon & Co* (1897) 2 AC 22; *Lacocque v Beauchemim* (1897) AC 458; *Attorney General for Canada v Standard Trust Co of New York* (1911) AC 498; *Re Express Engineering Works Ltd* (1920) 1 Ch 466.

<sup>33</sup> The *1890 Directors Liability Act* extended liability to promoters. A promoter was defined as a person who was a party to the preparation of the prospectus but did not include any person acting in a professional capacity for persons procuring the formation of a company (section 3(2)).

In Australia see for example in New South Wales section 140(1)(c) of the *Companies Act 1936* (the legislation introducing the *1890 Directors Liability Act* to New South Wales) which imposed potential civil liability on the promoter.

<sup>34</sup> See Gross “*Company Promoters*” (1972); note at (1970) 86 LQR 493; *Gower (1992)* at Chapter 12.

common law calls for an approach that is purposive having regard to the fiduciary duty that arises and which is fundamentally a question of fact.<sup>35</sup>

The underlying feature of promotion is the concept of being involved in the establishment of the issuer of securities. In *Twycross v Grant*<sup>36</sup> a promoter was defined as a person who:

“undertakes to form a company with reference to a given project, and to set it going and who takes the necessary steps to accomplish that purpose”.<sup>37</sup>

In *Whaley Bridge Calico Printing Co v Green*<sup>38</sup> the following observation was made:

“The term promoter is a term not of law but of business, usefully summing up in a single word a number of business operations familiar to the commercial world, by which a company is generally brought into existence.”<sup>39</sup>

It is critical to appreciate the concept by reference to the judicial intention that underpinned the development of the concept. This is well illustrated in *Whaley Bridge Calico Printing Company*<sup>40</sup> where Bowen LJ said the concept of promotion is based on the equitable relief that the court would grant to prevent the abuse of undue influence. In other words, the court approached the task from the perspective of identifying if the circumstances should give rise to equitable obligations of good faith to prevent secret profits being obtained:

“In every case the relief granted must depend on the establishment of such relations between the promoter and the birth, formation and floating of the company as render it contrary to good faith that the promoter should derive a secret profit.”<sup>41</sup>

The purposive approach is further demonstrated by the persons who have been held to be promoters in the early case law.<sup>42</sup>

<sup>35</sup> See for example *Twycross v Grant* (1877) 2 CPD 469; *Emma Silver Mining Company v Grant* (1899) 11 Ch D 918; *Jubilee Cotton Mills v Lewis* (1922) 1 Ch 100 and [1924] AC 958. For a modern illustration see *Elders Trustees v Reeves* (1987) 78 ALR 228 (FCA, Gummow J).

<sup>36</sup> *Twycross v Grant* (1877) 2 CPD 469 (this case involved a civil action under the 1867 *Material Contracts Act* against alleged promoters).

<sup>37</sup> *Ibid* at 541 per Cockburn LJ. In Australia to similar effect see *The Wheal Ellen Gold Mining Company, NL v Read* (1908) 7 CLR 34 at 42-3 (Higgins J).

<sup>38</sup> *Whaley Bridge Calico Printing Company v Green & Smith* (1880) 5 QBD 109.

<sup>39</sup> *Ibid* at 111 per Bowen LJ.

<sup>40</sup> *Ibid* at 111. See also *Gower* (1992) at 297.

<sup>41</sup> *Ibid* at 111. See also *Elders Trustees v Reeves* (1987) 78 ALR 228 at 234. This is an important case because it lays bare the motivation of the nineteenth century courts in developing the concept of promotion. Fundamentally, the courts approach to defining the concept of promotion was results driven.

<sup>42</sup> See for example the list contained in Halsburys Laws of England, chapter 7(1), paragraph 38.

The point is also demonstrated by the circumstances where promotion has not been established. The clearest example is a solicitor undertaking normal professional duties.<sup>43</sup> However, the case law also suggests that a solicitor or accountant may face liability if other acts are done by that person, for example if the person agrees to become a director or agrees to find such persons<sup>44</sup> - i.e. active exertion to achieve the success of the proposal beyond the provision of professional advice.<sup>45</sup>

While ambiguity with the promoter concept may be desirable in ensuring the correct persons are caught where fiduciary duty considerations are involved<sup>46</sup> imprecision is undesirable in the *Corporations Act* context.<sup>47</sup> From the fiduciary duty perspective, issues of promoter liability can be resolved by the promoter acting in good faith towards the company. Therefore it is clearly the case that the promoter can take the steps that are necessary to avoid liability. The position cannot so clearly be resolved in relation to *Corporations Act* prospectus liability because of the different context under which the concept arises.

The *CLERP Fundraising Paper* correctly identified that the range of people that may be promoters was unclear and of uncertain width.<sup>48</sup> It was therefore suggested the concept should be removed in favour of a clearly defined list of people who can properly accept responsibility for the prospectus and undertake due diligence inquiries.<sup>49</sup>

The changes made by the enactment of *CLERP Act* were therefore clearly desirable.

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<sup>43</sup> Illustrated by *Re Great Wheal Polgooth Company* (1883) 53 LJ Ch 42.

<sup>44</sup> See facts of *Tyrell v Bank of London* (1862) 11 ER 934 (solicitor acquired interest in asset acquired by the issuer). Cases such as *Lydney & Wigpool Iron Ore Company v Bird* (1886) 33 Ch D 85 and *Bagnall v Carlton* (1877) 6 Ch D 371 are also frequently cited as authority for this proposition. However these cases are not directly on point.

<sup>45</sup> The cases establish that it is intended that promoter liability can attach to persons who have played a relatively minor part in the establishment of the company - see *Jubilee Cotton Mills v Lewis* supra at 965 (per Viscount Lindley). In Australia see *Tracy v Mandalay Pty Ltd* (1953) 88 CLR 215.

<sup>46</sup> It is clear that the courts continue to resist attempts to clearly define the boundaries of fiduciary relationship because to do so would undermine the equitable basis of the remedy - see explanation in *Boardman v Phipps* [1969] 2 AC 46 at 123 (Lord Upjohn).

<sup>47</sup> A similar observation is made by Professor Gower - see *Gower* (1992) at 297.

<sup>48</sup> *CLERP Fundraising Paper* at 45.

This problem had also been noted by the Lonergan Committee in 1992 but no useful solution had been proposed - merely that an expert who is a member of a due diligence committee should not be treated as a promoter (*Lonergan Committee Report* at paragraphs 26 and 229).

<sup>49</sup> It is suggested that promoters will not be involved in the management of the issuer - *Ibid* at 46. It is noted that to the extent the promoter is directing decisions involving the issuer that person may face liability as a defacto director. Proposal No. 13 of the *CLERP Fundraising Paper* was therefore that the persons liable should not include promoters unless they are liable as directors or in some other capacity.

### 3.2 COMPARATIVE ANALYSIS WITH OTHER KEY JURISDICTIONS

Before discussing the scope of the damages remedy created by CA section 729, it is helpful to contrast the Australian position with the civil liability regime in other key jurisdictions.

#### United Kingdom Position

The *1890 Directors Liability Act* formulation of civil liability had carried through in an unchanged manner in the United Kingdom legislation until the *Companies Act 1985*.<sup>50</sup>

The *Financial Services Act 1986* and *Financial Services and Markets Act 2000* has adopted a slightly different formulation, although the net position is unlikely to be greatly changed. In relation to listing particulars, liability is in the following terms:

“Any person responsible for listing particulars is liable to pay compensation to a person who has:

- (a) acquired securities to which the particulars apply; and
- (b) suffered loss in respect of them as a result of any [misstatement].”<sup>51</sup>

The persons responsible for listing particulars are the issuer, directors and proposed directors, each person who accepts responsibility for part of the listing particulars and each other person who has authorised the contents of the listing particulars.<sup>52</sup> *The Public Offers of Securities Regulations 1995* provides an identical regime applies in relation to prospectuses where listing is not to occur.<sup>53</sup>

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<sup>50</sup> See Section 67 of *Companies Act 1985* (England).

<sup>51</sup> Section 90 of *Financial Services and Markets Act 2000*.

<sup>52</sup> Regulation 6 of the *Financial Services and Markets Act (Official Listing of Securities) Regulations 2001*.

<sup>53</sup> The liability provisions are Regulations 13-15 of *The Public Offers of Securities Regulations 1995*.

### United States Position

Section 11 of the *Securities Act* 1933 is based on the English companies legislation but with a variety of refinements.<sup>54</sup>

Section 11 permits the recovery of a specified sum of money<sup>55</sup> based on the difference between the issue price of the security and its market price at certain specified times where a registration statement:

“contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading”.<sup>56</sup>

The remedy is popularly perceived to be a form of strict liability because there is no defence provided to the issuer. In that regard it is seen as the most rigorous liability provision of the United States securities legislation and more onerous than the liability provisions in other jurisdictions.

However, for others involved in the capital raising process the available defences means the liability regime is very similar to its English antecedents and the other jurisdictions such as Australia based on them (the liability is described as “presumptive liability” in the United States).

The remedy is available against every person<sup>57</sup> who signed the registration statement, every director and proposed director, every expert who has prepared a report or certified part of the registration statement and every underwriter. Unlike the position in other jurisdictions, the United States liability regime specifically imposes a culpability standard, being the standard of reasonableness required of a prudent man in the management of his own property.<sup>58</sup>

In addition to Section 11 liability, a seller of securities faces potential liability under Section 12(2) of the *Securities Act* 1933. Section 12(2) has broad application to any sale of securities that

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<sup>54</sup> The changes were seen in 1933 to reflect a need to curb the more feverish pace at which American finance had developed (HR Rep No 85, 73d Cong, 1st Sess 4 (1933) at 9 - cited in *Folk I* (1969) at 14).

Many of the differences between the English and United States legislation in 1933 have now been conformed - for example imposing liability on experts and underwriters. However there remains significant differences in denying the issuer a defence, the measure and preconditions to damages and the specific imposition of the standard of conduct required - see *Folk I* (1969) at 14-7.

<sup>55</sup> The measure of damages is described below.

<sup>56</sup> Section 11(a) of *Securities Act* 1933.

<sup>57</sup> Section 11(a) of *Securities Act* 1933. The signing requirements are set out in Section 6 (the issuer, its principal executive officer, its principal financial officer, its principal accounting officer or comptroller and a majority of the board of directors).

<sup>58</sup> Section 11(c) of *Securities Act* 1933. Changed from a fiduciary standard in 1934 - see footnote 116 of Chapter 1.

involves a misleading statement.<sup>59</sup> It is not restricted to sales pursuant to a prospectus.<sup>60</sup> Like Section 11, the objective of section 12(2) is to place a burden on the seller to investigate and disclose all material facts whether or not he intended to cheat the buyer.<sup>61</sup> The standard of care imposed by section 12(2) of “reasonable care” would seem to have been intended to impose a lower standard than under section 11.<sup>62</sup> The remedy is a statutory form of rescission providing only for the return of the security in exchange for the price paid.<sup>63</sup>

The key limitation of section 12(2) is its limitation to the “seller” of securities. In that respect it is narrower than the section 11 remedy. It was recently finally established after many years of debate that persons included in the capital raising process who are not directly involved in the passing of title cannot be considered to be sellers, significantly limiting the scope of section 12(2).<sup>64</sup>

Canada similarly largely replicates the civil liability regime created by the *Securities Act* 1933 of the United States. In each significant province an investor has a civil remedy against the issuer (or a seller of a control block), any underwriter, any director of the issuer and a person who has consented to a part of the prospectus (expert report).<sup>65</sup> The available remedies are damages

<sup>59</sup> Section 12(2) provides that any person who offers or sells a security by interstate means:

“by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him...to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such a security, or for damages if he no longer owns the security”.

<sup>60</sup> In that respect its analogue in Australia would be to provisions such as section 999 and section 1000 of the *Corporations Act* described in Section 5.2.

<sup>61</sup> See *Kaminsky (1976)* at 237-9.

<sup>62</sup> See the discussion of the legislative history in *Note (1981)* at 385-7. The legislative background to section 12(2) is murky. The initial genesis would seem to have been a legislative restatement of fraud (the tort of deceit) which was expanded to cover negligent conduct subject to the reasonable care defence. Reasonable care did not necessarily have the requirement of investigation set out in section 11.

The distinction between care and investigation was not accepted by Professor Folk who argued that the standards have a similar connotation - *Folk 2 (1969)* at 207-14. This is supported by the decision of *Sanders v John Nuveen & Co* 619 F 2d 1222 (7th Cir 1980) (note the criticisms of this approach by Justice Powell in the Supreme Court denial of certiorari 450 US 1005 at 1009-11). For recent questioning of such a high standard see *Associated Randall Bank v Griffin, Kubik, Stephens & Thompson* 3 F 3d 208 (7th Cir 1993).

It has also been argued that a higher standard is involved - *Kaminsky (1968)* at 275-771. The *ALI Federal Code* had suggested a distinction between care and investigation - section 287(5).

<sup>63</sup> *Pfeffer v Cressaty* 223 F Supp 1165 (D Md 1968) at 757.

<sup>64</sup> See *Pinter & Dahl* 486 US 622 (1988) and *Gustafson v Aloyd Co* 115 S Ct 1061 (1995). For recent analysis in the light of this jurisprudence see *Letsou (1996)*; S. M. Bainbridge “Section 12(2) after *Gustafson*” (1996) 50 Bus Law 1231; E. J. Weiss “Section 12(2) after *Gustafson*: What Questions Remain?” (1996) 50 Bus Law 1209; S. Thel “Section 12(2) of the Securities Act: Does Old Legislation Matter?” (1995) 63 Fordham L Rev 1183.

<sup>65</sup> See for example *Ontario Securities Act RSO Act 1990*, section 130; *Alberta Securities Act SA (1981)*, section 168; *British Columbia Securities Act RSBC 1996*, section 131.

modelled on section 11 and rescission (against the issuer or seller and the underwriter) modelled on section 12(2). There are few differences in approach to the United States model.<sup>66</sup>

### 3.3 MEASURE OF DAMAGES

The key issue that arises in assessing the civil liability remedy is the nature and scope of the damages that are available to an investor if liability is established. As noted above, the *SIRC Report* had identified the unavailability of a remedy to purchasers in the secondary market and reliance issues as fundamental difficulties with the civil liability remedy under the companies legislation.

The legislative response was to adopt a remedy fashioned on the *Trade Practices Act*. Against that background the section 729 damages remedy will be assessed.

#### Historical Background

In analysing the scope and operation of the damages remedy in section 729 it is helpful to appreciate the legislative background and case law relating to the damages remedy provided for in the prospectus liability provisions prior to the *Corporations Law*.

The *1890 Directors Liability Act* formulated the damages remedy available against each relevant person in the following terms:

“[the defendant is] liable to pay compensation to all persons who subscribe for or purchase any shares or debentures on the faith of a prospectus for any loss or damage sustained by reason of [a misstatement]”.

As noted above, the Australian legislation continued with this formulation prior to the enactment of the *Corporations Law*. This formulation continues largely unchanged in England and many other Commonwealth countries. The courts were united in their view that this legislative formulation of civil liability gave rise to a tortious measure of damages, based on the measure of damages in deceit:

“I am of the opinion that the measure of damages and such claim is precisely the same as in an action of deceit ... In my judgement the effect of the section in the original Directors Liability Act was merely to eliminate the element of fraud from the cause of action based on misrepresentation in a prospectus, and to give the same remedy in the

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<sup>66</sup> See the analysis in *Thompson (1988)* at 284-6 with respect to the British Columbia statute.

statutory conditions for an untrue misrepresentation as for a fraudulent misrepresentation.”<sup>67</sup>

The award of damages under the *1867 Material Contracts Act* was considered to involve the same approach. By providing that the non-disclosure of a material contract constituted “deemed” fraud the same measure of damages as in deceit was applied by the courts.<sup>68</sup>

The common law and statutory remedies can therefore be considered together. Unfortunately for an investor, a tort based damages remedy will not facilitate a straightforward mechanism to obtain an award of damages in the event of a prospectus misstatement.

A review of the relevant case law clearly establishes that there are three key issues that have hampered potential actions in this area, ambiguity in measuring the quantum of loss, the need to show causation of loss and the need to show reliance.

### Measuring Loss

The first of these considerations, determining the amount of loss, has posed difficult factual questions for courts. The legal test can be simply stated. That is a plaintiff who suffers loss from a prospectus misstatement is entitled to damages equal to the difference between the “actual value” of the securities subscribed for at the date of allotment and the amount paid for those securities.<sup>69</sup>

However, in the securities law context that formulation begs the question as the difficulty of establishing the “actual value” of a security is obvious. The debate surveyed in Section 1.6 of Chapter 1 outlines some of the difficulties that could arise. The way the courts have traditionally grappled with that difficulty provides an interesting insight into the problem.

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<sup>67</sup> *Clark & Ors v Urquhart; Stracey & Ors v Urquhart* [1930] AC 28 per Lord Atkin at 67 - see also Viscount Sumner at 56 and Lord Tomlin at 76. The earliest authority to this effect was *McConnel v Wright* [1903] 1 Ch 546 (see Cozens Hardy LJ at 558). In *Clark v Urquhart* Viscount Sumner said (at 56) that the term “compensation” was selected in the statute because it represented the difference between the actual value of the securities and the price paid for them and at the same time avoided the invidious association of damages with dishonesty in such a connection.

The *Financial Services and Markets Act 2000* continues to use the term “compensation” with the result that the same principles should continue to apply in England.

<sup>68</sup> See for example *Macleay v Tait* [1906] AC 24; *Cackett v Keswick* [1902] 2 Ch 456. See analysis in *Heerey (1967)* at 433-5.

<sup>69</sup> *Peek v Derry* (1887) 37 Ch D 541; *McConnel v Wright* supra; *In re Blair Open Hearth Furnace Company, Limited* [1914] 1 Ch 390; *Clark & Others v Urquhart* supra; *Potts v Miller* (1940) 64 CLR 282; *Bundle v Davies & Ors* [1932] NZLR 1047.

For these purposes it was long established that the valuation must be conducted at the date of acquisition - *Davidson v Tulloch* (1860) 3 Macq 783.

First, the courts were quick to reject the market price of a security as necessarily being an appropriate measure of actual value at the time of allotment of securities, on the basis that the market price may be affected by the false statements in the prospectus and other similar factors.<sup>70</sup>

“in finding the fair or real value of shares at the time of purchase or allotment, the fact that it is then possible to sell the shares at a price that will go far to cover the outlay may be disregarded, if that price is delusive or fictitious is the result of a fraudulent prospectus, manipulation of the market or some other improper practice on the part of the defendant or those associated with him”

From a policy perspective that concern is sound. Even devotees of the efficient market hypothesis and the information economists acknowledge that liability rules are necessary to prevent the mispricing of securities by misstatement.<sup>71</sup>

Second, the courts have generally considered that it is permissible to look at later events to determine what the actual value of the securities was at the time of allotment.

“because those events may show, for instance, that what the shares might have sold for was not their true value or that it was a worthless company”<sup>72</sup>

These two general principles still do not assist in getting to the heart of the issue of “actual value”. One convenient heuristic the courts have applied is a prima facie presumption that the assets as represented in a prospectus are taken to be equivalent to the money paid for the subscription of securities. Therefore, for example, to the extent that the net assets of the issuer were not as represented the amount by which they fall short equals the loss suffered by investors.<sup>73</sup> However, as noted by Dixon J in *Potts v Millar* that rule of convenience can be of no assistance when the misstatement has no relationship to the value of the shares in question.<sup>74</sup>

In addition, such an approach to securities valuation is quite rudimentary and inappropriate to modern circumstances. The leading modern valuation techniques are the capitalisation of estimated future maintainable profits and discounted cash flows analysis.<sup>75</sup>

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<sup>70</sup> See *Potts v Miller* supra at 299 (Dixon J) referring to *Twycross v Grant* (1877) 2 CPD 469 at 485 and *Broome v Speak* (1903) 1 Ch 546 at 606.

<sup>71</sup> See Section 1.6.

<sup>72</sup> *Potts v Millar* supra, citing *Derry v Peek* (1887) 37 Ch D at 592, 594.

<sup>73</sup> *McConnel v Wright* supra at 555 (Collins MR). The case involved a prospectus that stated the company had acquired various assets (company shareholdings) when that was not the case at the time of allotment.

<sup>74</sup> *Potts v Millar* supra at 300.

<sup>75</sup> See W. Lonergan “*The Valuation of Businesses, Shares and other Equity*” 1992, Longman Professional.

The above analysis is not to suggest a contemporary court would apply the traditional securities case law without regard to modern valuation principles. Clearly it will be open to the plaintiff to lead evidence as to “true value” by reference to these considerations. The point of the analysis is to demonstrate the lack of meaningful precedent in this area with the result that an investor faces uncertainty in pursuing a civil action.<sup>76</sup>

A contemporary illustration of possible difficulties of assessing “true” value is the considerable literature that has developed to the effect that issuers underprice their securities when undertaking initial public offerings.<sup>77</sup> Research suggests a systemic material underpricing of IPO’s in many jurisdictions.<sup>78</sup> Various theories have been developed for the underpricing that has been observed, including economic incentives for underwriters to underprice so as to reduce risk, so as to signal the quality of the issuer and to act as an incentive to keep uninformed investors in the market.<sup>79</sup> One theory that has been put forward in the United States is that underpricing acts as insurance against legal liability having regard to the measure of damages under section 11 of the *Securities Act* (see discussion of that damages measure below).<sup>80</sup>

Irrespective of the basis for such underpricing, if underpricing could be established it would complicate any assessment of the “true” value of the security.

### Causation

A second issue that causes difficulty in the context of securities offerings is the tort requirement that causation of loss be established by the plaintiff seeking to recover damages.<sup>81</sup> In many cases it has been argued by the defendant that the cause of the plaintiff’s loss did not arise as a result of

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<sup>76</sup> The difficulties with these principles is also illustrated in the United States material outside of the section 11 context by analysis such as *Mullaney (1977)*.

<sup>77</sup> For a survey of the literature and an empirical survey of IPOs in Australia in the 1992-3 period see *Ramsay & Sidhu (1995)* at 186.

A 10-15% discount to the expected trading price is traditionally provided for - see for example the data collected by PricewaterhouseCoopers “*Survey of Sharemarket Floats 2000*” (2001 @ PricewaterhouseCoopers) suggesting the average “stag profit” for large cap - floats (greater than A\$100 million market capitalisation) has ranged between approximately 45% and 2% in each year between 1992 and 2000, while the range for small cap floats was between approximately 20% and 5% for each year. In 2000 the averages were 25% and 5% respectively.

<sup>78</sup> In the *Ramsay & Sidhu* survey estimated at 11 - 14% (at 198). This was comparable to research conducted in a number of jurisdictions (see review of material at 187) and earlier Australian research (see discussion at 198-9).

It has been argued this anomaly arises in every country with a stock market - see T. Loughren, J.R. Ritter & K. Rydgvist “*Initial Public Offerings: International Insights*” (1994) 2 *Pacific-Basin Fin J* 3.

<sup>79</sup> See the literature survey at *Ramsay & Sidhu (1995)* at 188-191 and in *Rousseau (2000)* at 676-681.

<sup>80</sup> S.M. Tinic “*Anatomy of Initial Public Offerings of Common Stock*” (1988) 43 *Jnl of Fin* 789 and J.C. Alexander “*The Law Suit Avoidance Theory of Why Initial Public Offerings are Underpriced*” (1993) 17 *Uni of Cal LA L Rev* 17. For contrary arguments see P.D. Drake & M.A. Vetsuypens “*IPO Underpricing and Insurance Against Legal Liability*” (1993) 22 *Fin Mgmt* 64.

<sup>81</sup> See *Smith v Chadwick & Ors* (1884) HL (Eq) 187.

the prospectus misstatement but as a result of subsequent events.<sup>82</sup> This difficulty is most pronounced in cases where the prospectus offers securities in a company that does not have an established business and it is argued that the loss arose as a result of later mismanagement.<sup>83</sup>

As a result of the difficulties caused by the required proof of causation it has been suggested by some judges that the formulation of damages based on actual value of the security at the time of allotment may be expressed in too rigid terms.<sup>84</sup> However, apart from flagging the prospect of proposing a test that would make the task of the investor less difficult, no alternative formulation to the general test has been suggested in a subsequent case.

The difficulties faced by a plaintiff proving causation in many situations will be great. The leading Australian case of *Potts v Miller* clearly demonstrates this point. In that case the issuer became insolvent within a year of the prospectus being issued. While prospectus misstatement was established:

“the case was therefore one in which the appellant [the plaintiff] was bound to adduce some expert evidence to show that the value of the shares in the company, taking into account its assets in the business in which it was about to engage, was less than 20/- [the issue price]. Such evidence as exists points in the opposite direction. Several persons, admittedly very experienced in the theatrical business, had subscribed for substantial numbers of shares; the amount of capital sought was rapidly obtained; and the appellant was able to dispose of 500 of his shares soon after allotment for £1 each. The appellant failed to produce any evidence of damage, and, since damages were the gist of the action, he should have been non-suited.”<sup>85</sup>

The result of such an analysis would seem to be that unless the share price of an issuer falls significantly below the issue price of the securities soon after the issue takes place there may be

<sup>82</sup> See *McConnel v Wright* supra at 556 (Romer CJ). For the need to discount factors caused by later events as distinct from factors affecting true value at the time of calculation see *Gould v Vaggelas* (1985) 157 CLR 215 at 220-2.

For other notable illustrations of this principal in an early case see *Stevens v Hoare* (1904) 20 TLR 407 at 409 (company wound up 3½ years after prospectus issued where losses found to have arisen from later “foolish and improper transactions”).

<sup>83</sup> Such an argument does not auger well for claims of plaintiffs that may arise in relation to new economy offerings that do not perform as represented following the tech wreck of 2000. The case of *Potts v Millar* supra illustrates the difficulties (company established to acquire a theatrical business that was described at the time as highly speculative).

<sup>84</sup> See *Clark v Urquhart* supra at 68 (Lord Atkin):

“The formula in *McConnel v Wright* may be correct or it may be expressed in too rigid terms. I reserve the right to consider it if it should ever be in issue in this House.”

See also Dixon J in *Potts v Millar* supra at 298. Dixon J suggested that this concern is resolved by focusing on the causes in the loss of value of the security following the time of allotment. Inherent causes of a loss of value should be taken into account in assessing damages while extrinsic or later causes should be disregarded. This explanation is the basis of the comments made above.

<sup>85</sup> *Potts v Miller* supra at 309-10 (Williams J).

For a more flexible approach see the earlier case of *Shepherd v Broome* (1904) AC 342 where Lord Lindlay suggested that a company’s failure within a short time of the issue of a prospectus suggested prima facie evidence of some damage caused by untrue statements (at 347-8).

little point in pursuing a claim for prospectus misstatement. Clearly the court in *Potts v Miller* imposed a very high hurdle to recovery.

## Reliance

The need to prove reliance on the misstatement will also be a difficult issue in the typical prospectus context. On the traditional tort analysis the plaintiff must establish that they have relied on the relevant misstatements in the prospectus so as to establish liability.<sup>86</sup>

The earliest authority to the effect that reliance is necessary for the establishment of a right of damages for prospectus misstatement was *Macleay v Tait*,<sup>87</sup> a case involving the 1867 *Material Contracts Act*. A theme that will be returned to is the clear link between the concepts of reliance in the damages context and materiality of misstatement to establish prospectus liability in the first place.

The necessity for the establishment of reliance has been questioned from time to time under the statutory liability regime. The analysis in Section 1.6 clearly identifies the policy difficulties associated with requiring an investor to establish reliance on prospectus misstatement. At a basic level there is conflicting evidence of the degree to which investors, particularly retail investors, use prospectuses. However, irrespective, in the modern environment it is clear all investors will be harmed through such a misstatement. At its highest level this flows from concepts of information efficiency under the efficient market hypothesis,<sup>88</sup> but even in the absence of the validity of that policy underpinning, market efficiency is undermined by misstatement. As such, there is a strong policy grounding for rejecting the need to establish reliance by individual investors. It can therefore be suggested that development of the requirement with the tort of deceit in the Nineteenth century is no longer appropriate to modern public securities markets with intermediation in the investment process. However, there is no clear judicial support for that view.<sup>89</sup>

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<sup>86</sup> *In re Blair Open Hearth Furnace Company, Limited* supra.

<sup>87</sup> *Macleay v Tait* [1906] AC 24; see Lord Lindley at 31. The House of Lords approved the opinion of Thesiger LJ in *Sullivan v Mitcalfe* (1880) 5 CPD 455 and the decision of the Court of Appeal in *Nash v Calthorpe* [1905] 2 Ch 237.

<sup>88</sup> See for example *Pickholz & Horahan* (1982).

<sup>89</sup> For example in *Heerey (1967)* it is argued that the requirement in s.46 of the *Companies Act 1961* that the plaintiff subscribe for shares “on the faith of the prospectus” did not require reliance by the investor on the particular misstatement in the prospectus (at 435). However, that terminology had been used from the time of the 1890 *Directors Liability Act*.

In the United Kingdom it has been argued by some commentators that the change in the formulation of the legislation to permit the recovery of compensation for a person subscribed on the “faith of” a prospectus to a person who “suffered loss” has abolished the need for reliance - see for example “*Gore - Browne on Companies*” (looseleaf) at paragraph 11 - 3. As yet, there is no judicial support for that view.

The case law does suggest some flexibility in the manner in which reliance can be established as a question of fact. For example, in *Smith v Chadwick & Ors*<sup>90</sup> it was suggested in an action for deceit that if the court is satisfied that the statement is of such significance that it would be likely to induce investment and it is established the investor did invest, then reliance will be inferred.<sup>91</sup>

All of the above is heightened by the requirement that it is for the plaintiff to establish that loss has been suffered and the plaintiff will bear the burden of proof on that matter.<sup>92</sup>

### **Background to the *Corporations Law***

As noted above, the *SIRC Report* had contained a number of recommendations in relation to reform of the traditional damages remedy.

A key issue addressed was the traditional requirement of reliance. The SIRC Committee recommended that an investor acquiring shares pursuant to a prospectus should be presumed to have invested on the basis of all of the statements in the prospectus.<sup>93</sup>

The *SIRC Report* was therefore welcome for its focus on the reliance difficulties associated with the damages remedy. However, the analysis was incomplete in that the ambiguities associated with valuation issues and causation were not addressed.

In the implementation of both the *Corporations Law* and the *CLERP Act* review, it is extraordinary that none of the difficulties associated with the traditional remedy were addressed and there would appear to have been little consideration given to the *SIRC Report* recommendations. Instead, an entirely new general damages formulation based on section 82 of the *Trade Practices Act* was incorporated into the *Corporations Law* without modification.

No explanation was given as to why the language of the traditional remedy was no longer considered appropriate or why the adoption of the *Trade Practices Act* remedy would benefit the operation of the civil liability remedy.

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<sup>90</sup> (1884) 9 HL (Eq) 187.

<sup>91</sup> Ibid at 196 (Lord Blackburn).

<sup>92</sup> See *Stevens v Hoare* (1904) 20 TLR at 409 (Joyce J); *Potts v Millar* supra at 299 (Dixon J).

<sup>93</sup> Paragraph 6.2 of *SIRC Report*.

“A prospectus is a document which is produced expressly for the purpose of inducing persons to invest. Why should they then have to prove a subjective matter such as reliance on that document? It appears to the Committee that the provision is in this respect too onerous on the plaintiff.”

The *CLERP Act* has persisted with this formulation. None of the *Simplification Task Force Report on Fundraising*, the *CLERP Fundraising Paper*, or the Explanatory Memorandum to the *CLERP Bill* canvassed the adequacy of the formulation of the damages remedy or suggested changes were required.<sup>94</sup>

### Damages under the Trade Practices Act

As with the jurisprudence on section 52 generally, the jurisprudence that has developed in Australia on the damages remedy under section 82 of the *Trade Practices Act* has resulted in a great expansion of traditional remedies.

It is interesting to review the *Trade Practices Act* jurisprudence on the damages remedy under section 82 to assess the likely reaction to the issues that have posed difficulties in the historical analysis of damages for prospectus misstatement. What clearly comes out of such a review is that turning to section 82 will not greatly assist in the resolution of the key ambiguities identified above that are relevant to prospectus misstatement actions. These difficulties can be expected to continue to cause difficulties for plaintiffs in seeking damages for a prospectus misstatement under the *Corporations Act*.

The original *CL* section 1005 followed TPA section 82 in giving a right to “recover the amount of the loss or damage” that is suffered “by conduct of another person”. Under current *CA* section 729 the remedy is a right to “recover the amount of the loss or damage” that is suffered “because an offer of securities under a disclosure document contravenes subsection 728(1)”. The primary change is therefore to substitute the word “because” for “by”.

In the trade practices context the use of the words “by” and “amount of loss or damage” have been described as an “apparent telescoping of what to the common law would be issues of causation, remoteness and measure of damages”.<sup>95</sup>

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<sup>94</sup> This author raised with the members of the *Simplification Task Force* the issue of why changes were not proposed at the time its proposals were made. The response was that they did not believe it was within their mandate to recommend changes of that nature.

<sup>95</sup> *Munchies Management Pty Ltd v Belperio* (1988) 58 FCR 274 at 286 (FCA, Gummow & Lee JJ). See also *Elna Australia Pty Ltd v International Computers (Aust) Pty Ltd (No. 2)* (1987) 16 FCR 410 at 419 (FCA, Gummow J).

It has been suggested that there have been two philosophical approaches to the construction of section 82 - see J. D. Heydon “*Damages Under the Trade Practices Act*”, Chapter 3 in “*Essays in Tort*” (Finn (editor), 1989) at 45. The first is to approach the issue from the analogues of the common law while the second is to treat the issue as a matter of statutory construction where common law analogues are very much secondary.

The first issue that must be addressed is the measure of damages that applies under a section 82 action. In 1986 the High Court had said in *Gates v The City Mutual Life Assurance Society Limited*<sup>96</sup> that a tortious measure of damages is generally appropriate.

“The Court is not bound to make a definitive choice between the two measures of damages so that one applies to all contraventions to the exclusion of the other. However, there is much to be said for the view that the measure for damages in tort is appropriate in most, if not all, Part V cases, especially those involving misleading or deceptive conduct or the making of false statements. Such conduct is similar both in character and effect to tortious conduct, particularly fraudulent misrepresentation and negligent misstatement.”<sup>97</sup>

A more ambivalent approach is reflected in the subsequent High Court decision of *Marks v GIO Australia Holdings Limited*.<sup>98</sup> The court there said that section 82 does not limit the damages recoverable to those applicable in tort.<sup>99</sup> The majority suggested the basic test in establishing damages is to compare the actual position of the claimant with the position in which that person would have been in but for the contravening conduct.<sup>100</sup> It was noted in this regard that in appropriate circumstances assistance in determining damages can be derived from common law principles.<sup>101</sup> As such, a casual connection between the damage and the conduct engaged in is critical and it has been suggested that the measure of damages in tort would lead to the same result in most cases.<sup>102</sup>

A judicial approach to the measure of damages under the CA statutory prospectus liability regime based on the *Derry v Peek* heritage is therefore likely. As such, the issues of measurement of

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<sup>96</sup> *Gates v The City Mutual Life Assurance Society Limited* (1985-6) 160 CLR 1.

<sup>97</sup> *Ibid* at 14 (Mason, Wilson and Dawson JJ). See also Gibbs J at 6-7. The facts of the *Gates Case* clearly demonstrate the significance of an award of compensatory damages as distinct from expectation damages (the contractual standard). The *Gates Case* involved a misstatement made in connection with the purchase of an insurance policy. The misstatement had the effect that the plaintiff was not insured for loss when it had been represented that he would be. The High Court confirmed that the remedy available to the insured was limited to the amount paid in insurance premiums rather than an amount equal to the payout under the insurance policy that had been represented.

<sup>98</sup> *Marks & Ors v GIO Australia Holdings Limited & Ors* (1998) 196 CLR 494; 158 ALR 333; Again, the facts were significant (credit facility offered by a financial institution involving misrepresentation as to the interest rate that would be charged).

<sup>99</sup> McHugh, Hayne & Callinan JJ said at 158 ALR 344 - 5:

“the very fact that ss82 and 87 may be applied to widely different contraventions of the Act, some of which can be seen as inviting analogies with torts such as deceit or with equity but others of which find ready analogies in the common law or equity, shows that it is wrong to limit the apparent clear words of the Act by reference to one or more of these analogies.”

<sup>100</sup> *Ibid* at 346.

<sup>101</sup> *Ibid* at 346 (McHugh Callinan and Hayne JJ).

<sup>102</sup> See S. Lo “*Expectation Damages Under the Trade Practices Act s. 82*” (2001) 9 Comp & Consumer LJ 174 at 176 - 7.

loss, causation and reliance are likely to be critical considerations, albeit expressed in the more general considerations of the modern jurisprudence.<sup>103</sup>

The result at its most fundamental level is that the ambiguities of the debate concerning the “true value” of the relevant securities that is addressed above will arise again.<sup>104</sup> As such the debate on this issue for purposes of prospectus misstatement is not greatly advanced.

Concepts of causation and reliance are also likely to have a continuing role to play in the Trade Practices jurisprudence. For example, the role of causation had been recognised by the High Court in the decision of *Wardley Australia Limited v State of Western Australia*<sup>105</sup>:

“The statutory cause of action arises when the plaintiff suffers loss or damage “by” contravening conduct of another person. “By” is a curious word to use. One might have expected “by means of”, “by reason of”, “in consequence of” or “as a result of”. But the word clearly expresses the notion of causation without defining or elucidating it. In this situation, section 52(1) should be understood as taking up the common law practical or commonsense concept of causation recently discussed by this Court in *March v Stramare (E & M H) Pty Ltd* (1991) 171 CLR 506 except insofar as that concept is modified or supplemented expressly or impliedly by the provisions of the Act.”<sup>106</sup>

However what must be clearly appreciated in dealing with the trade practices damages cases is the strong expression by the courts of a perception that the policy underpinnings of the *Trade Practices Act* are advanced by adopting a flexible approach to relevant common law principles. As Gummow J said in *Elna Australia Pty Ltd v International Computers (Australia) Pty Ltd*:<sup>107</sup>

<sup>103</sup> In *Leadenhall Australia Ltd & Ors v Peptech Ltd* (1998) 33 ASCR 307 (SCNSW, Hunter J) the application of a strict *Potts v Miller* assessment of damages for purposes of section 82 of the *Trade Practice Act* and the then section 1005 of the *CL* was rejected as appropriate for the facts of that case (misleading statement as to the status of vendor shares as restricted securities under the ASX Listing Rules in periodic financial statements) - see at 342 and 353. However, damages were not awarded because of the lack of reliance and causation. On appeal, in *Leadenhall Australia Ltd & Ors v Peptech Ltd* (2001) 39 ASCR 265 (SCNSW (CA, Meagher, Handley & Giles JJA) the NSW Court of Appeal declined to decide whether or not the relevant damages should be assessed by the principles set out in *Potts v Miller* as a result of the *Marks* decision (at 276).

<sup>104</sup> In the trade practices context the rule is illustrated by cases such as *Gould v Vaggelas* (185) 157 CLR 215 at 220 (Gibbs CJ); *Kizbeau Pty Ltd v WG & B Pty Limited* (1995) 184 CLR 281 at 291 (Brennan, Deane, Dawson, Gaudron & McHugh JJ); *Netaf Pty Limited v Bikane Pty Limited* (1990) 92 ALR 400 at 495 (Full FCA, Sheppard & Pincus JJ); *O’Kelly Holdings Pty Limited v Dalrymple Holdings Pty Limited* (1993) 45 FCR 145 at 159 (Full FCA, Lee J); *Morgan Corporate Limited v GWG Leviny Pty Limited* (1995) ATPR 41 - 414 at 40, 591 (NSW, CA, Meagher JA).

The trade practices cases make it clear that value is to be assessed at the date of purchase: *Lubidineuse v Bevanere Pty Limited* (1985) ATPR 40 - 597 at 46, 834 (FCA, Wilcox J). The value is determined by the price a willing purchaser would have to pay a vendor not unwilling but anxious to sell: *O’Kelly Holdings Pty Limited v Dalrymple Holdings Pty Limited* (1993) 45 FCR 145 at 159 per Pincus J (Full FCA).

<sup>105</sup> *Wardley Australia Limited v State of Western Australia* (1992) 175 CLR 514, 109 ALR 247.

<sup>106</sup> *Ibid* at 525 (Mason CJ, Dawson, Gaudron and McHugh JJ). In *March v Stramare (E & M H) Pty Limited* (1991) 171 CLR 506, for purposes of determining damages in tort, the High Court rejected a “but-for” test for determination of causation so as to leave policy considerations to be determined as an element of remoteness. The High Court said a “but-for” test would not operate satisfactorily in cases where there are multiple acts involved in the chain of causation. Value judgements and policy considerations should necessarily intrude on the court’s analysis of causation in these circumstances (at 516 - 7 per Mason CJ).

<sup>107</sup> *Elna Australia Pty Ltd v International Computers (Australia) Pty Ltd* (1987) 16 FCR 410 (FCA, Gummow J).

“In construing section 82 it is appropriate to bear in mind such matters as the scope and purpose of Part IV and V of the TP Act as directed significantly to issues of economic loss or damage, the wide range of subject matters dealt with ... and the apparent telescoping of what to the common law would be issues of causation, rather than the nature of damages. However, common law analogies will not necessarily offer sufficient guidance, particularly where, as is the case with the TP Act, the statute evinces an intention to supplement the common law or, further, to travel into new fields.”<sup>108</sup>

In addition, rigidity that may have existed at common law in the calculation of damages will not necessarily apply. In *Wardley Australia Limited v State of Western Australia*, the High Court in confirming that economic loss is recoverable under section 82 said:<sup>109</sup>

“it would not be right to conclude that the measure of damages recoverable ... necessarily coincides with the measure of damages applicable in an action for deceit or in an action for negligent misrepresentation. The measure of damages ... can only be ascertained after a thorough analysis of those provisions ... [by] which the statutory cause of action may be maintained.”

Establishment of causation is said to be a two stage process.<sup>110</sup> First it must be shown the misleading conduct resulted in acts being done by the plaintiff. Second a sufficient link must be established with the loss or damaged suffered.

In connection with the second requirement, a sufficient nexus, it follows from the above that the contravening conduct need not be the only contributing cause to the loss that is suffered.<sup>111</sup> Conduct will be actionable if it plays some part, even if only a minor part<sup>112</sup> of a contributing cause.<sup>113</sup> Consistent with this approach a “but for” test does not apply<sup>114</sup> and a misrepresentation will be actionable if it contributed in a “non-trivial” way to the causative process.<sup>115</sup>

In connection with the first requirement of establishing the required nexus, the normal manner to establish causation is by proof of reliance. In *Wardley Australia Limited v State of Western Australia*, the High Court said that where a misrepresentation is involved:

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<sup>108</sup> Ibid at 419.

<sup>109</sup> (1992) 175 CLR 514 at 525.

<sup>110</sup> See *Australian Protective Electronics Pty Limited v Pabflow Pty Limited* (1996) ATPR 41 - 524 at 42, 736 per Parker J (WA Full Ct).

<sup>111</sup> See *Elders Trustee & Executor Co Ltd v E G Reeves Pty Limited* (1987) 78 ALR 193 at 242 (FCA, Gummow J); *Elna Australia Pty Limited v International Computers (Aust) Pty Limited* (1987) 16 FCR 410 at 419 (FCA, Gummow J).

<sup>112</sup> *Gould v Vaggelas* (1985) 157 CLR 215 at 236. See also *Pengilly* (1994) at 140.

<sup>113</sup> *Mologonov v O'Brien* (1982) 67 FLR 311 at 326 (Ellicott J).

<sup>114</sup> *National Australia Bank Ltd v Cunningham* (1990) ATPR 41-047 at 51,624 (Jenkinson J). See also the reference to *March v Stramare (E & MH) Pty Limited* above.

<sup>115</sup> *Ricochet Pty Ltd v Equity Trustees Executor and Agency Co Ltd* (1993) 41 FCR 229 at 235 (Lockhart, Gummow and French JJ) dismissing *National Australia Bank Ltd v Cunningham* Ibid.

“as at common law, acts done by the representee in reliance on the misrepresentation constitute a sufficient connexion to satisfy the concept of causation.”<sup>116</sup>

However, it is an open question whether causation could be established without reliance. In the securities law context it has been suggested that it is sufficient that the misrepresentation played a “significant” role which “materially influenced” the decision to invest.<sup>117</sup> In other cases it has been considered sufficient that reliance be established by derivative impacts on the plaintiff without direct reliance by the plaintiff on the defendant’s conduct. For example, in a passing off action the public may be misled, causing damage to a rival business. That observation is best illustrated by the case of *Janssen - Cilag Pty Limited v Pfizer Pty Limited*.<sup>118</sup> Lockhart J said in that case that:

“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 Act or its purpose to warrant the suggestion that the right of an applicant for damages under s. 82 is confined to the case where he has relied upon or personally been influenced by the conduct of the respondent”.

Beyond this it has been suggested that in an appropriate case reliance need not be established.<sup>119</sup> Nonetheless other cases have refused to make orders of damages where the suggestion of reliance has been rebutted.<sup>120</sup>

In the securities law context, this gives rise to the interesting question of whether an argument could be mounted by reference to the efficient market hypothesis that causation and reliance could be established by the markets reliance on the alleged misstatement. In the United States the Supreme Court has approved of the so called “fraud on the market theory” to establish reliance for general securities law actions.<sup>121</sup> That theory is predicated directly on the policy underpinnings of the efficient market hypotheses. The theory assumes that in an open and developed securities market the price of securities will be determined by the available material information released by the issuer, with the result that the court will presume reliance on that

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<sup>116</sup> (1992) 175 CLR 514 at 525 (Mason CJ, Dawson, Gaudron and McHugh JJ). See also *Henjo Investments Pty Limited v Collins Marrickville Pty Limited (No 1)* (1988) 39 FCR 546 at 558 per Lockhart J (Full FCA).

<sup>117</sup> *Milner v Delita* (1985) 61 ALR 557 (Lockhart J) at 572 - 3.

<sup>118</sup> (1992) 37 FCR 526; 109 ALR 638 (FCA, Lockhart J). The case involved a claim for damages by a drug manufacturer against a competitor for lost sales of product caused by misleading statements made by the competitor as to the qualities of its products.

<sup>119</sup> See discussion in R. S. French “*The Action for Misleading and Deceptive Conduct: Future Directions*” in Lockhart (Ed) “*Misleading or Deceptive Conduct: Issues and Trends*” 1996, Federation Press at 302 and *Henjo Investments Pty Limited v Collins Marrickville Pty Limited (No 2)* (1989) 40 FCR 76 at 93 per Lee J (Full FCA).

<sup>120</sup> See *Jones v Acfold Investments Pty Limited* (1985) 6 FCR 512 (would have proceeded with transaction irrespective); *Pappas v Soulac Pty Limited* (1983) 50 ALR 231 (not influenced by the misrepresentation); *Argy v Blunts and Lane Cove Real Estate Pty Limited* (1990) 26 FCR 112 (representation must be a real inducement). See also the *Leadenhall* case at footnote 103.

<sup>121</sup> *Basic, Inc v Levinson* 485 US 224 (1988).

information by investors.<sup>122</sup> That reliance can be rebutted by a defendant providing evidence to the contrary. In addition to cloaking the theory in economic terms the court noted that such an approach facilitates the policy of the securities laws by recognising that investors are affected by information and investors should be entitled to rely on the integrity of those markets.

Having regard to the above analysis, it would do fundamental violence to the orthodox approach of the Australian courts to suggest that there would be any basis for a fraud on the market theory to be applied to the Australian provisions.<sup>123</sup>

However, what would clearly be desirable in the Australian context would be for there to be consideration of whether the efficient market hypothesis could be seen as a reason to move away from requirements of reliance and causation, particularly for these small investors who do not make their investment decision based on disclosure documents or do not have the skills to do so. To the extent that noise theory is a valid concern, that does not undermine the desirability of providing a remedy that reflects the way the modern securities markets work and the way modern investors, or categories of modern investors, actually make decisions.

In the United States context, the appropriateness of the fraud on the market theory has similarly been criticised from the policy perspective in its rejection of traditional determinants of liability.<sup>124</sup> However, as noted above the presumption of reliance can also be justified by more modest objectives based on policy. Ultimately, it could be left for the defendant to argue that the relevant reliance should not be presumed.

The approach of the *Janssen-Cilag case* could also be utilised to draw narrower conclusions. For example, it has been suggested that where an investor relies on the advice of an investment advisor who has relied on a prospectus disclosure, the necessary causation and reliance should be made out.<sup>125</sup>

Clearly the approach adopted will depend upon the attitude of the courts having regard to the orthodox analysis outlined above and the possibilities created by the *Trade Practices Act*

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<sup>122</sup> Ibid at 241-9 (Blackmun J).

<sup>123</sup> See also *Crocker (1998)* at 15.

<sup>124</sup> See Macy & Miller "Good Finance, Bad Economics: An Analysis on Fraud on the Market Theory" (1990) 42 Stan L Rev 168; Macey, Miller, Mitchell & Netter "Lessons from Financial Economics: Materiality, Reliance and Extending the Reach of *Basic v Levinson*" (1991) 77 Virg L Rev 1017.

<sup>125</sup> *Crocker (1998)* at 14. It is argued that the flow of information through the advisor to the investor is sufficiently "direct and proximate" based on the analysis of Einfeld J in *Haynes v Top Slice Deli Pty Limited* (1995) ATPR (Digest) 46-147.

jurisprudence. It would be hoped that a modern Australian court would look at the policy arguments outlined above<sup>126</sup> to reject the continued relevance of strict reliance in the context of prospectus misstatement. What the provisions do not create is certainty for prospective plaintiffs.

CA section 729 has replaced the term “by” with the term “because”. The issue is whether that change alters any of the analysis set out above. It has been suggested that this terminology may be narrower and would imply a need for the loss to flow directly from the offer, imposing a greater reliance requirement that suggested by the trade practices jurisprudence.<sup>127</sup> However, that view is open to question because linguistically little seems to flow from the change.

### Secondary Market Purchaser Liability

A good illustration of the continuing difficulties with the damages remedy is the question of whether a person who acquires shares in the secondary market following the issue of a prospectus has a right to claim damages under CA section 729.

It could be expected that the need for resolution of this issue would be quite straightforward from a policy perspective, as in an initial public offering it is clear that the prospectus disclosures are intended to form the foundation of the public body of information that will be available on the issuer as a basis for trading on its securities on the stock market. However, this issue is not explicitly addressed in the damages remedy and involves considerable uncertainty.

As noted above, the issue was subject to explicit recommendations in the *SIRC Report* which proposed a straightforward test for resolution of the issue.<sup>128</sup>

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<sup>126</sup> See text at footnote 89.

<sup>127</sup> *Croker (1998)* at 78.

By way of contrast, in the United Kingdom which now uses the terminology of permitting recovery where loss is suffered “as a result of” a misstatement (section 90 of the *Financial Services and Markets Act 2000*). It has been argued that as a consequence reliance is not required - see A. Besorai “*Disclosure of Tentative Information By Listed Companies (1995)*” 16 *Comp Law* 263 at 268.

<sup>128</sup> SIRC Committee Report at paragraph 6.3:

“The Committee believes that a subscriber to the issue should be presumed to invest on the faith of the prospectus. ... It is difficult to determine how far this presumption can be taken in the case of secondary market-purchases. On the one hand, those purchases may never ever have seen the prospectus. On the other hand, in the absence of malpractice, the prospectus is the source of the market information about the company. The Committee suggests that the following is a fair balance between these arguments:

- (a) the right to compensation for purchases on the market is limited to losses suffered in respect of purchases within six months of the issue of the prospectus (its normal life);
- (b) the purchaser, unlike a subscriber, must establish that he or she invest on the faith of the prospectus;
- (c) the defendant is not liable if he or she can establish that at the time of purchase it was unreasonable for the purchaser so to rely.”

At general law the traditional view was that the only person that could pursue a claim in damages for a prospectus misstatement was a person subscribing under the prospectus. In *Peek v Gurney*<sup>129</sup> the House of Lords said the object of a prospectus was to provide an investor with the necessary information to make an informed decision to accept the offer to invest under the prospectus, not to make after market purchases.<sup>130</sup>

However, as discussed in Section 5.3 that policy premise has recently been tested in the tort cases of *Al-Nakib Investments (Jersey) Ltd v Longcroft*<sup>131</sup> and *Possfund Custodian Trustee Ltd v Diamond*.<sup>132</sup> The *Al-Nakib case* followed the traditional approach. However, in the *Possfund case*, it was questioned whether it would be reasonable for the courts to recognise that a purpose of disseminating a prospectus is to facilitate trading by secondary purchases, such that a duty of care could arise for purposes of the tort of negligence.<sup>133</sup>

On the other hand, the statutory damages remedy traditionally was much more specific in its ambit. The *1890 Directors Liability Act* provided that damages would be available “to all persons who subscribe for or purchase” securities on the “faith of a prospectus”. As such, the generally held view was that no statutory remedy was available to secondary market purchasers because the remedy was limited to persons who acquire the securities under the offer made by the prospectus.<sup>134</sup>

Under the *Corporations Law*, the TPA section 82 damages formulation of permitting recovery to a “person who suffers loss or damage by conduct of another” was adopted as the relevant test. Under *CA* section 729 the formulation is altered slightly to “loss or damage because an offer of securities contravenes” the misstatement prohibition.

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<sup>129</sup> *Peek v Gurney* (1873) LR 6 HL 377, a case involving a claim under the tort of deceit for prospectus misstatement.

<sup>130</sup> To similar effect see *Scott v Dixon* (1859) 29 LJ Ex 620; *Andrews v Mockford* [1896] 1 QB 372. In *Andrews v Mockford* liability was established where the false statements were repeated by the company in telegrams and the investor had relied on those later telegrams.

That is not to say the issue of secondary market reliance was not a matter of debate - see the description of the debate in England in the 1930's described in *Barnett (1934)* at 15-6.

<sup>131</sup> (1990) 3 All ER 321.

<sup>132</sup> (1996) 2 All ER 774.

<sup>133</sup> Reference is made to *Gower (1992)* at 498 and the view that once prospectuses specifically state that one of their purposes is to lead to admission to listing, the decision in *Peek v Gurney* seems outmoded and the decision in the *Al-Nakib case* should be reviewed (Ibid at 789).

<sup>134</sup> See for example the presumption expressed in *Possfund Custodian Trustee Ltd v Diamond* (1996) 2 All ER 774 at 781 - 2.

For an analogous view as to whether the use of the word “as a result of” from the historical term “acquired” as used in the *Financial Services and Markets Act 2000* of the United Kingdom may allow recovery for secondary market purchasers see *Hofler (1995)* at 71 and *Gleeson & Blumenthal (1999)* at 432 - 6.

Notwithstanding the ambiguity of the position, the flexibility of the *Trade Practices Act* based remedy could be argued to facilitate recovery by secondary market purchasers. As discussed above, indirect reliance may be sufficient to establish causation.<sup>135</sup> Clearly there is nothing in *CA* section 729 that specifically limits the application of the remedy to persons that acquire securities under the relevant prospectus, as was the case in the past. The issue is now whether principles of causation and reliance will limit the remedy to persons who have so acquired the securities.

For the reasons outlined above, the presumption would be that the broad concepts of causation and reliance would so limit the remedy. This would be so unless the principles of the *Janssen-Cilag case* could be expanded to cover that situation.<sup>136</sup>

However, the availability of this argument may have been restricted by the use of the term “because of” instead of “by” in the restated *CA* section 729. It has been suggested the natural meaning of the term “because of” limits potential plaintiffs to those persons who subscribe for or purchase securities pursuant to the prospectus.<sup>137</sup>

What is clear from this analysis is that the legislation has not clearly addressed the position of secondary market purchasers.

### **A Comparison with the United States**

In contrast to the ambiguity of the damages remedy in the *Corporations Act*, section 11 of the *Securities Act* is quite precise in the measure of damages so that proof of damages is not an impediment to the availability of the remedy. In framing section 11 of the *Securities Act* 1933, it was recognised that the common law requirements in the United States for the recovery of damages requiring knowledge, reliance and causation imposed “almost insurmountable barriers to recovery”.<sup>138</sup> As such it was considered necessary to modify each of these matters to achieve the objectives of the legislation. In the damages context that objective is achieved in the following ways.

First, purchasers need not prove that they have relied on any misstatement in the prospectus. Therefore, there is no need to establish a causal connection between the misstatement and the

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<sup>135</sup> See the discussion of the *Janssen - Cilag* case above.

<sup>136</sup> In *Croker (1998)* it is argued that there is not sufficient proximity for that principle to apply (at 15-16).

<sup>137</sup> *Croker(1998)* at 78.

<sup>138</sup> *Douglas & Bates (1933)* at 174. See also *Shulman (1933)* at 229.

purchaser's loss.<sup>139</sup> The only qualification to this is that reliance must be established where the issuer has generally distributed an earnings statement covering a period of at least 12 months following the effective date of the registration statement.<sup>140</sup>

Further, a limited causation defence arises if the defendant can prove the loss resulted from factors other than the misstatement.<sup>141</sup> However the burden of proof is on the defendant and it can be expected that proof on these matters is difficult.<sup>142</sup>

Second, the damages remedy does not require any quantification of loss. The recoverable loss is specified in the legislation in a very specific manner. The amount recoverable is capped at the price the security was offered to the public.<sup>143</sup> The amount recoverable equals the difference between the amount paid for the security and any of the three following amounts:<sup>144</sup>

1. The value of the security at the time the suit was brought.
2. The price at which the security was disposed of in the market before the suit was brought.
3. The price at which the security was disposed of after suit but before judgement if those damages are less than the damages calculated on the first test above.

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<sup>139</sup> Section 12(2) rescission similarly does not require reliance because of the limited pre-condition that the sale of the security be "by means of" a misstatement - see *Sanders v John Nuveen & Co* 619 F2d 1222 (7th Cir 1980).

<sup>140</sup> Section 11(a) provides:

"If such person acquired the security after the issuer has made generally available to its security-holders an earning statement covering a period of at least 12 months beginning after the effective date of the registration statement, then the right of recovery under this sub-section shall be conditioned on proof that such person acquired the security relying on such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person."

<sup>141</sup> Section 11(e) provides:

"If the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable."

The original *Securities Act* provision provided for recovery of the difference between the price paid for a security less amounts received for the sale of the security or income received.

<sup>142</sup> For analysis see *Note (1976)* and P. Grier "A Methodology for the Calculation of Section 11 Damages" (1999) 5 *Stanf Jnl of Law, Business & Finance* 99.

Where there are dramatic declines in securities markets the qualification can be of relevance - see *Feit Case* (at 586); *Beecher v Able* 435 F Supp 397 (SDNY 1997); *Note (1976)* at 222-5.

<sup>143</sup> Section 11(f) provides:

"In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public."

<sup>144</sup> Section 11(e).

Third, there is no requirement to prove a nexus between the purchaser of the securities and the defendant. The rights are available to the holder of any of the securities issued under the registration statement whether or not the plaintiff is the original subscriber or purchaser or was a subsequent purchaser.<sup>145</sup> This issue is quite relevant in the United States where the underwriting practice is for investors to acquire securities from the underwriter rather than the issuer.

However, a significant limitation of the regime is that the section 11 remedy is only available to a shareholder who can trace the securities held to those offered under the registration statement.<sup>146</sup> This need to establish “linear privity” may impose a significant burden on secondary market purchasers where shares are traded on an homogeneous basis.<sup>147</sup> If shares are issued by a listed company and do not form a large part of the issued capital of the company the requirement may be difficult to establish for a secondary market purchaser of securities. It would seem that there is no good policy basis for imposing a requirement of linear privity in that it is artificial to view a disclosure document as only being relevant to the investment decision of persons taking securities under the disclosure document. As such, the approach reflected in the *SIRC Report*<sup>148</sup> would be more attractive from the policy perspective.

### Some Conclusions on the Damages Remedy

The ambiguities associated with the damages remedy is a key ongoing deficiency that severely limits the usefulness of the civil liability remedy to investors and thereby undermines the deterrent effect of the Australian regime.

This should not be a surprise to the legislature or regulators, as it has been an observation made over a number of years in Australia<sup>149</sup> and was a key consideration in the development of the United States provisions. Indeed, the *Corporations and Securities Bill 1974* had proposed a similar formulation of liability to that of the United States.<sup>150</sup> However, there has been no

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<sup>145</sup> For general discussion see *Curnin & Ford (2001)*; M. Lopez “Aftermarket Purchases and Right of Action under Section 11(a) of the Securities Act of 1933” (2000) 19 Annual Rev of Banking Law 655 and B. Murray “Aftermarket Purchases Under 11 of the Securities Act of 1933” (1999) 73 St Johns L Rev 633.

<sup>146</sup> See *Barnes v Osofsky* 373 F 2d 269 (2d Cir 1967); *Colonial Realty Corp v Brunswick Corp* 257 F Supp 875 (SDNY 1966).

However, see *Hertzberg v Dignity Partners, Inc* 191 F 3d 1076 (9th Cir 1999) (linear privity presumed where only one public offering undertaken).

<sup>147</sup> For strong criticism of the impediments caused by this requirement as developed by the United States courts in decisions such as *Gustafson v Alloyd Co* 513 US 561 (1995) (holding that section 12(2) only applies to initial purchasers of securities) see *Sale (2000)*. For the contrary view see *Curnin & Ford (2001)* at 202 - 206.

<sup>148</sup> See text at footnotes 7 and 8.

<sup>149</sup> See the discussion in *Heerey (1967)* and in the *SIRC Report* as outlined above.

<sup>150</sup> See section 171(3) and (4) of the Bill. Compensation was expressed only to be available to a person who subscribed for the securities to which the prospectus related (*ie* secondary market purchasers were not included).

appetite to deal with the issues in a meaningful way with the development of the *Corporations Law* and the *CLERP Act*.

The first key deficiency is the ambiguity of the measure of damages recoverable. This is a matter of proof for the plaintiff and is ultimately subjective in nature in Australia. To the extent losses are considered to arise from later events, even where material misstatements are found in the disclosure document, recovery will be limited.<sup>151</sup> Much will depend on the preparedness of courts to sheet responsibility for losses to the disclosure document. The history in Australia to date has not been encouraging in that regard.

Against that background, to the extent prospectus misstatement arises in the Australian context from the 2000 tech wreck the prospects of recovery are not good.<sup>152</sup>

It is clear that comparative analysis with the United States would have been a good starting point for the development of an effective regime in this context.

The second key deficiency is the failure to identify the investors who might have a cause of action against the specified defendants. While recent case law and the *Trade Practices Act* jurisprudence suggests courts may have some flexibility in expanding the class of plaintiff to include secondary market purchases, it would not be unreasonable to expect the legislation to offer some degree of clarity as to who is entitled to enforce the right of action given for a prospectus misstatement.<sup>153</sup> That is important not just from the perspective of plaintiff rights but also as a matter of fairness to defendants.

A simple regime is reflected in the recommendations of the *SIRC Report* and is available by reference to a comparative analysis with the United States provisions. They would have been a good starting point for consideration of this issue.

The third key deficiency is the ongoing uncertainty as to the relevance of causation and reliance. Causation and reliance were largely removed as relevant requirements in the United States

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<sup>151</sup> At the time of adoption of the *Securities Act* 1933, one observer noted that the common law remedies in tort and contract were fashioned for a variety of disparate transactions and needed to be moulded to provide an effective deterrence mechanism for the floatation of securities - see *Shulman (1933)* at 227-8. This comment is particularly apt to the measure of loss issue (at 229-231).

<sup>152</sup> Particularly if the issuer was a start-up enterprise and new business strategies are implemented following the prospectus offering period as a result of changes in the business environment. See the analogy to *Stevens v Hoare* and *Potts v Millar* at footnotes 82 to 85 above.

<sup>153</sup> Indeed the indeterminacy in this area extends to questions of whether defendants listed in section 729 might have direct claims of action against each other under the section. This arises because the remedy is available to a person who suffers loss or damage because of the contravention. To the extent that a person exposes themselves to a liability to investors as a result of contraventions also caused by others involved in the offering process they may agree they have suffered such loss or damage. This issue is important to the extent traditional rights of contribution are not available - see Section 10.2 below.

provisions to provide a remedy intended to better perform an effective deterrence role. Requirements of causation and reliance were clearly significant impediments to recovery under the Australian law prior to the enactment of the *Corporations Law*. The reliance requirement, in particular, is no longer an appropriate requirement from the policy perspective as discussed above. The *Trade Practices Act* jurisprudence certainly facilitates far greater flexibility for an Australian court to reach a better outcome, but there will remain indeterminacy until a body of case law develops.

What would have been a much more satisfactory resolution of all of these issues would have been to approach the issue from the solutions adopted in the United States, the *SIRC Report* recommendations, the debate as to the relevance of market efficiency (or noise for that matter) and the way in which various categories of investors in the contemporary securities markets make investment decisions. Then it would have been possible to address the traditional requirements of causation and reliance in a manner that assisted in better defining the scope of the civil liability remedy.

### **More General Cultural Impediments**

Even if a more effective civil remedy could be formulated for Australia, serious questions would continue to exist as to whether that remedy would be used by investors.

The comparative historical analysis in Section 1.4 and Section 1.5 shows that it is only in the United States that there is a meaningful enforcement record and then only in the last 30 years has the prospectus misstatement remedy been utilised. The reasons for that differing experience are clearly cultural. This is well illustrated by the contrast between the United States and Canada. Both jurisdictions now have largely identical securities laws but in Canada there continues to be little enforcement of the laws through civil actions.

If Australian legislators wanted to make the civil remedy more relevant it is clear that the cultural reasons for failing to enforce civil remedies would need to be addressed. The reasons for a lack of enforcement can be easily catalogued.

First, the cost of pursuing civil causes of action are very high. For a small retail investor who has likely only lost a modest amount of money it is unrealistic to expect that such an investor is equipped to personally pursue a civil remedy.

Second, large institutional investors who hold large portfolios of securities will have diversified the consequences of a lost investment through the portfolio. As such, the relative pain caused

from an individual loss is not felt to the same degree as far a small investor. Such an investor will typically prefer to take the “wall street walk” of selecting another investment rather than pursue legal rights when a loss has been suffered.

Finally, as a cultural matter Australians have historically not been enthusiastic about resorting to the courts to resolve disputes.

These reasons for not pursuing civil remedies are general to the securities laws and would need to be addressed at the general level to be changed, rather than through the prospectus misstatement remedy itself. In that regard the United States litigation experience has been noted in Section 1.3.<sup>154</sup> The extent of the litigation explosion in the United States certainly does not suggest that is a preferable legal climate.

There are also tentative signs of change in the Australian environment.

There may be some basis to suggest that an increase in class action pursuit of securities laws matters will be likely in Australia.<sup>155</sup> The commencement of a class action by shareholders of GIO Holdings Limited against its directors arising out of the ill-fated takeover launched by AMP Limited in 1998 is seen as a dramatic development in Australia.<sup>156</sup>

The prospects of class actions have been assisted by the introduction of facilitative court rules for the Federal Court of Australia.<sup>157</sup> In addition recent case law has been supportive of the pursuit of class actions.<sup>158</sup> The power of ASIC to pursue a civil action on behalf of a class of investor under section 50 of the *ASIC Act* is also an important element in changing the Australian approach to pursuing securities laws actions.<sup>159</sup>

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<sup>154</sup> See text accompanying footnotes 122 to 129 of Chapter 1.

<sup>155</sup> See the discussion in J. Donnan “*Class Actions in Securities Fraud in Australia*” (2000) 18 C & SLJ 82.

<sup>156</sup> See description in K. Svoboda “*Corporate Governance Issues Arising from the 1998 - 1999 AMP - GIO Takeover*” (2000) 18 C & SLJ 395 at 403. Class actions relating out of corporate collapses at the end of the 1980s and early 1990s were also not unusual.

<sup>157</sup> Part IVA of the Federal Court of Australia Act 1976. Of course, at the time of writing, the continued uncertainty of the jurisdiction of the Federal Court arising out of the *Re Wakim; ex parte McNally* (1999) 73 ALJR 839 results in difficulties in pursuing a *Corporations Law* based action.

<sup>158</sup> In *Carnie v Esanda Finance* (1995) 182 CLR 398 the High Court held that for purposes of representative proceedings under the NSW Supreme Court Rules “common interest” could exist if the interest of the parties was based on separate contracts. In *Wong v Silkfield* (1999) 199 CLR 255 the High Court adopted a broad view as to the requirement that members of a class share a substantial common issue of law or fact.

<sup>159</sup> Section 50 allows ASIC to bring civil proceedings for “damages for fraud, negligence, default, breach of duty, or other misconduct” arising in connection with an investigation undertaken by ASIC. A breach of Part 6D.3 is not clearly encompassed by that provision.

However, there remain significant structural impediments to pursuing class actions in Australia.<sup>160</sup> Those impediments include continuing disincentives arising from the traditional approach that the costs of an action follow the event. While the plaintiff lawyers pursuing the matter risk exposure to the costs of the action there will continue to be a reticence to pursue securities actions.<sup>161</sup>

In addition, the requirements that a class action involve substantial common issues of law and fact will prove difficult in the context of Chapter 6D.3. This is because the civil liability remedy continues to involve issues of reliance and causation on the part of individual investors. This can be contrasted with the United States where section 11 has a simple formulation as to the measure of damages and where judicial concepts such as the fraud on the market doctrine have been developed that presume reliance on generally known information when trading in securities.

### 3.4 THE RELEVANCE OF MATERIALITY

A significant distinction between *CA s.729* and its predecessor provisions is that there is no explicit requirement that the misstatement must be material. As set out in Section 2.5 above the concept of materiality has been a cornerstone of the civil liability regime for prospectus misstatement since the *1890 Directors Liability Act*.

The removal of the requirement of materiality from the civil liability remedy was made without any discussion or analysis of the issue in the background materials to the *CLERP Act*. It would seem removal of the requirement was made as a matter of simplification.

Some commentators have noted this change with alarm. However, even though an explicit recognition of the concept would have been desirable from a policy perspective, case law analysis suggests there will be little change in the practical assessment of potential liability.

Clearly there is a need for a de-minimis threshold to prevent irrelevant or inconsequential misstatements giving rise to potential liability. The primary filtering device in the *Corporations Law* to prevent irrelevant or inconsequential statements being actionable has traditionally been the requirement that the misstatement be “material”. However, the requirement of a material misstatement is only one of the filtering devices that apply to civil liability. The relevance of causation and reliance to the recovery of damages also act as filtering devices.

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<sup>160</sup> See Donnan *supra* at 94 and 96.

<sup>161</sup> Section 332J(2) of the Federal Court of Australia Act enables the court to make orders requiring class members to contribute to costs but there has been little move to encourage United States contingency fee arrangements that might provide a more appropriate risk/reward for legal advisors.

It is clear that there is a relationship between materiality, as discussed in Section 2.5, and requirements of causation and reliance. It has already been noted that common law cases tended to confuse issues of materiality and reliance.<sup>162</sup> A good illustration of this relationship is the 1904 decision of *De La Cour v Clinton*<sup>163</sup> where the court said:

“I hold this misstatement not to have been material or, in other words, the plaintiffs have not sustained any loss or damage by reason of this untrue or incorrect statement.”<sup>164</sup>

The implied threshold of materiality is also illustrated by the *Misleading & Deceptive Conduct Provisions* jurisprudence, which similarly provides a civil remedy for misleading or deceptive conduct without specifying any materiality threshold. In *NRMA v Fraser* the Full Federal Court confirmed that it would only order an injunction in relation to an alleged misstatement in a disclosure document where the misstatement was material.

“Errors and omissions to have that potential must be relevant to the topic about which it is said that the respondents’ conduct is likely to deceive. The need for an applicant to establish materiality is of particular importance in a case like the present one where the proposal is complex, and involves difficult questions of commercial judgment and matters of degree and conjecture as to the future about which there is a room for a range of honestly and reasonably held questions.”<sup>165</sup>

On the basis of these criteria certain misstatements in the *NRMA Case* were disregarded as immaterial.<sup>166</sup>

It follows from the above analysis that the removal of the need for materiality from section 729 is not likely to have an impact on the potential liability of persons facing liability under that section.<sup>167</sup> Nevertheless, it may have been more desirable for the materiality requirement to have been maintained as a matter of business perception and to maintain the historical connection with the concept.

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<sup>162</sup> See text accompanying footnote 132 in Chapter 2.

<sup>163</sup> *De La Cour v Clinton; Trechman v Calthorpe* (1904) 20 TLR 420 (Joyce J) and 706 (Court of Appeal), an action brought under the 1890 *Directors Liability Act* and the 1867 *Material Contracts Act*.

<sup>164</sup> *Ibid* at 420. See also the statements made as to the relationship of materiality and loss in the New Zealand criminal case of *R v Rada Corporation Limited* (1990) 5 NZCLC 96, 413 cited at footnote 138 in Chapter 2.

<sup>165</sup> *NRMA Case* at (1995) 15 ACSR 603.

<sup>166</sup> For example a false statement that NRMA Limited “controlled” NRMA Insurance Limited - *NRMA Case* at 613-614.

Support for these statements have been expressed in later cases such as *Ampolex Ltd v Mobil Exploration & Producing Australia Pty Ltd* (1996) 19 ACSR 354 (FCA, Sackville J) at 378.

<sup>167</sup> To similar effect see *Croker* (1998) at 76.

By way of contrast to the approach now taken in Australia, it was considered at the time of adoption of the *Securities Act* that the removal of requirements of causation and reliance from section 11 resulted in the common law considerations relevant to those requirements being merged into materiality issues.<sup>168</sup> It can be argued that this would be a clearer solution for the civil damages remedy than the apparent reverse situation that now applies in Australia particularly having regard to the criticisms set out in Section 3.3 as to the requirements of causation and reliance.<sup>169</sup>

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<sup>168</sup> See *Shulman (1933)* at 250.

<sup>169</sup> To the extent that principles of causation and reliance were to be modified as advocated in Section 3.3, there would be a more pressing need to recognise materiality as a filtering device.

## CHAPTER 4

### THE DUE DILIGENCE DEFENCES

#### 4.1 THE DEFENCES TO LIABILITY

Under the *Corporations Act* the defences are uniform for both criminal and civil liability. That was not the case prior to the enactment of the *CLERP Act*.

The defences are:

- a due diligence defence for misleading or deceptive statements or omissions (*CA* section 731).
- a reasonable reliance defence for information given by another person (*CA* section 733(1)).
- a withdrawal of consent defence for named proposed directors, underwriters and advisors (*CA* section 733(3)).
- a lack of knowledge defence for misleading or deceptive statements or omissions in an offer information statement or profile statement (*CA* section 732).<sup>1</sup>
- a lack of knowledge defence for new circumstances giving rise to an obligation to update a disclosure document (*CA* section 733(4)).

This chapter contains some preliminary observations in relation to the structure of the due diligence defences, as well as a description of the structure of the due diligence inquiries that are customarily undertaken in Australian securities offerings. Chapters 7 to 9 contain a more detailed analysis of the due diligence defences as they apply to the various participants involved in the capital raising process.

#### Development of Defences

A formal defence regime for potential prospectus civil liability has been a feature of the statutory regime since the *1890 Directors Liability Act*.

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<sup>1</sup> This defence is discussed in Section 6.2.

The first defence in that legislation was the basic defence that came to be known in the United States and then in other jurisdictions as the “due diligence defence”, expressed in the following classical terms:

“he had reasonable ground to believe, and did up to the time of the allotment of the [securities] believe that the statement was true.”<sup>2</sup>

Further, there were “expertisation” defences<sup>3</sup> in the *1890 Directors Liability Act* to provide a defence for reliance on statements made by experts if it was believed that:

“he had reasonable ground to believe that the person making the statement, report or valuation was competent to make it.”<sup>4</sup>

Finally, there were withdrawal of consent defences.

Under the companies legislation prior to the enactment of the *Corporations Law* there were a variety of potential defences, but still based closely on the model of the *1890 Directors Liability Act*. The civil liability provision of the *Companies Code* 1981 (section 107) had a basic due diligence defence, an expertisation defence and withdrawal of consent defence for the persons specified to face primary liability. There was a separate liability regime and defence for experts.<sup>5</sup> On the other hand, the criminal liability provision (section 108) had an immateriality defence, a basic due diligence defence and an inadvertence defence.

### **SIRC Report**

The *SIRC Report* did not propose any change to the defences available to directors and the other persons who were liable under the then civil liability provisions.<sup>6</sup>

However, in proposing the imposition of civil liability on underwriters, the *SIRC Report* considered that the burden imposed upon underwriters and brokers should not be as great as for directors and other persons with liability. The view was expressed that this be achieved by providing a reasonable inquiry defence for underwriters with some specification as to what the underwriter should do to satisfy its responsibility.<sup>7</sup> Second, the recommendation was made that

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<sup>2</sup> Section 3(1)(a) of the *1890 Directors Liability Act*.

<sup>3</sup> Using the vernacular adopted in the United States to describe this defence.

<sup>4</sup> Section 3(1)(b) of the *1890 Directors Liability Act*.

<sup>5</sup> Added to the legislation following recommendations of the Cohen committee in 1945 - see footnote 83 to Chapter 1.

<sup>6</sup> *SIRC Report* at paragraph 6.4.

<sup>7</sup> *Ibid.* The proposal was to equate the duty sought to a professional duty of care.

there be a statutory right of indemnity for the underwriter against the persons primarily liable, limited by levels of culpability.<sup>8</sup>

### Original Corporations Law

The *Corporations Law* reforms were unsatisfactory in a number of ways.

The criminal regime reflected a continuation of the previous approach where the defence was based on the classic due diligence formulation, without any of the more detailed subtleties of drafting such as a separate “expertisation” defence for reliance on expert reports.<sup>9</sup>

The regime of defences for the civil remedy was extraordinarily convoluted. The original formulation of those defences in the *Corporations Bill* 1988 revealed numerous drafting defects, resulting in the need for substantial amendments. It is interesting that this occurred against a background where the *SIRC Report* had commented that no changes to the due diligence defences were necessary. Great interpretative difficulties arose from the complex structure of the defences. The initial provisions are a further example of the *Corporations Law* failing to express appropriate theoretical policy underpinnings in the formulation of the liability regime.

For convenience of analysis it is helpful to classify the original *CL* defences according to inquiry based defences and consent based defences.<sup>10</sup>

The inquiry based defences were traditional due diligence defences and variants, predicated on the defendant establishing enquiries have been made in relation to the accuracy of the disclosures contained in the prospectus.

<sup>8</sup> Ibid.

<sup>9</sup> With the reversal of the onus of proof as to materiality discussed in section 2.1.

<sup>10</sup> The complexity of the regime of defences is illustrated by the following table that summaries the defences available to each person involved in the capital raising process who had primary civil liability.

Person	Consent Based	Inquiry Based	Other
All persons	-	-	1007
Issuer	-	1011	-
Person authorising/causing issue	1010(3)	1011	-
Director/Proposed Director	1008(2), (3), (4)	1008A(2), (3), (4)	-
Promoter	-	1011	-
Underwriter/Broker	1009(2)	1011	-
Expert	1009(2), 1009(3)(a)(b), 1010(1)	1009(3)(c)	-
Adviser	1009(2), 1009(4)(a)(b), 1010(1)	1009(4)(c)	-
Accessory	-	-	-

The consent based defences dealt with circumstances where consent to the participation in the prospectus was withdrawn or where consent could be given to restrict liability to certain parts of the prospectus.

An illustration of the difficulties caused by the regime and its poorly formulated policy can be illustrated by referring to the following four examples.<sup>11</sup>

*Section 1011 Defence* - The key due diligence defence that had general applicability to a number of the persons involved in prospectus preparation was that contained in section 1011 of the *Corporations Law*.

The defence was taken directly from section 85 of the *Trade Practices Act*.<sup>12</sup> The legislature, despite using the words "due diligence" in the section, had moved away from the customary formulation of the due diligence defence as set out in the *1890 Directors Liability Act* and as used in other jurisdictions. The section 1011 defence was unusual in that it contained three separate defences which can be referred to for convenience as the mistake limb,<sup>13</sup> the reliance limb<sup>14</sup> and the precautions limb of section 1011.<sup>15</sup>

The drafting of the defence was structurally flawed and inappropriate to the prospectus liability context. This should have been apparent from a review of the *Trade Practices Act* genesis of the defence. Section 85 of the *Trade Practices Act* provides a defence to criminal prosecutions brought under the consumer protection provisions of that legislation.<sup>16</sup> That section was substantially amended in 1977 in a manner that could have been expected to give rise to unexpected consequences if there were to be judicial consideration of section 1011.

<sup>11</sup> These are illustrative only. A variety of uncertainties and anomalies arose under many of the defences in the table above. See the more detailed discussion in *Golding (1993)* and *Golding (1997)*.

<sup>12</sup> Which itself was based on the antecedent United Kingdom consumer protection legislation, Section 24 of the *Trade Descriptions Act 1968*.

The section 1011 defence provided that there would not be liability if it is proved that the misstatement:

- “(a) was due to a reasonable mistake;
- (b) was due to reasonable reliance on information supplied by another person; or
- (c) was due to the act or default of another person, to an accident or to some other cause beyond the defendant’s control;

and, in a case to which paragraph (c) of this subsection applies, that the defendant took reasonable precautions and exercised due diligence to ensure that all statements to be included in the prospectus [contained no misstatement].”

<sup>13</sup> Section 1011(1)(a) - a misstatement “due to a reasonable mistake”.

<sup>14</sup> Section 1011(1)(b) - a misstatement “due to reasonable reliance on information supplied by another person”.

<sup>15</sup> Section 1011(1)(c) and the proviso to section 1011(1) - a misstatement “due to the act or default of another person, to an accident or to some other cause beyond the defendant’s control” where the person “took reasonable precautions and exercised due diligence to ensure” there were no misstatements.

<sup>16</sup> The defence is not available in relation to civil liability proceedings, a significant distinction in the context of the *Corporations Law*.

In the first three years of its operation, section 85 of the *Trade Practices Act* required that a contravention be due to a mistake, to reliance on another or to the act of another and, in each case, that the person in question took reasonable precautions and exercised due diligence. In reviewing the defence in 1976, the *Swanson Committee Report*<sup>17</sup> recommended that the reasonable precaution and due diligence requirement be removed from the mistake and reliance limbs of the defence because the section as then drafted could operate “unduly harshly” and “could make excessive demands upon operations for preventative measures”.<sup>18</sup> As a consequence, the current formulation of section 85 was adopted in 1977 and suggests that reasonable precautions and due diligence are not required in relation to the mistake limb or the reliance limb of section 85.<sup>19</sup>

As the language of section 1011 was identical in all material respects to section 85, it would be reasonable to assume that similar conclusions can be drawn in relation to the regulatory intent underpinning section 1011. Such a result is unsatisfactory. It can hardly be the case that prospectus integrity would be enhanced where there is a strong legislative mandate that “due diligence” is not required in relation to the mistake limb or the reliance limb of section 1011.

From the policy perspective the only prospect of a satisfactory judicial interpretation of the mistake limb or reliance limb of section 1011 comes through the concept of “reasonableness” that qualified both limbs. Reasonableness is of course a concept that has had a long relationship to the prospectus liability defence.<sup>20</sup> As the term is quite elastic<sup>21</sup> in its application to particular fact situations it allows a court considerable scope to fashion appropriate rules of conduct. The Trade Practices case law recognises that reasonableness requires regard to be had to the relevant statutory prohibition in the legislation against which the defence is being raised, so as to assess the actions actually taken in the circumstances.<sup>22</sup> According to the Trade Practices case law reasonableness is an objective matter to be determined having regard to the circumstances of the case without the benefit of hindsight.<sup>23</sup> Having regard to the very different statutory context in

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<sup>17</sup> Trade Practices Act Review Committee “*Report to the Minister of Business and Consumer Affairs*” (1976, AGPS) (the “*Swanson Committee Report*”).

<sup>18</sup> See paragraph 9.144 of the *Swanson Committee Report*.

<sup>19</sup> See for example *Adams v Eta Foods Ltd* (1987) ATPR 40-103 (FCA, Gummow J) at 48,966. The Trade Practices cases make it clear that each limb has its own independent operation and the defendant need only establish the applicability of one limb to establish a defence - see for example *Adams v Eta Foods Ltd* (1987) ATPR 40-103 at 48,972; *Gardam v George Wills & Co Ltd* (No 2) (1988) ATPR 40-885 (FCA, French J) at 49,585.

<sup>20</sup> See *1890 Directors Liability Act* and its use of the term “reasonable grounds”.

<sup>21</sup> The concept has been described as “a plastic concept which has been adapted to specific cases without undue hardship to defendants” by one of the early commentators on the *Securities Act 1933* (United States) in justifying the appropriateness of the use of that concept for the liability provisions as they apply to different participants in the offering process - see *Shulman (1933)* at 251-2.

<sup>22</sup> *Wilkinson v Katies Fashions (Aust) Pty Limited* (1986) ATPR 40-721 (FCA, Jenkinson J) at 47,910.

<sup>23</sup> *Adams v Eta Foods Ltd* (1987) ATPR 40-831 at 48,966 (citing *He Kaw Teh v The Queen* (1985) 157 CLR 523 at 575) and at 48,967.

which section 85 of the *Trade Practices Law* exists and the different policy issues relevant to participants involved in the securities offering process it would be appropriate for courts to approach the concept of reasonableness in a different way to the typical trade practices context.<sup>24</sup> However, that outcome could not be assumed and the legislative history, as outlined above, suggested otherwise.

*Inadvertence Defence* - Section 996(2)(c) of the *Corporations Law* contained a defence in relation to criminal liability for omissions if the omission was “inadvertent”. The inadvertence defence had been a feature of the Australian securities law since the *Companies Code* 1981.<sup>25</sup>

There was no background material given as to the basis for the inclusion of the defence.<sup>26</sup>

There is no case law precedent available as to the meaning of the term in the context of criminal liability for prospectus misstatement. The appropriateness of the continued retention of the defence was not canvassed in the explanatory material released leading up to the enactment to the *Corporations Law* or the *SIRC Report*.

The term “inadvertence” has a similar flavour of unanticipated mishap that underpins the other due diligence defences referred to in this dissertation. However the general meaning of “inadvertence” focuses much more on concepts of failing to take care and being inattentive,<sup>27</sup> while the other due diligence defences only excuse conduct when reasonable care has been

<sup>24</sup> The key trade practices cases dealing with the due diligence defences are *Guthrie & Doyle, Dane & Bernback Pty Ltd* (1977) ATPR 40-037 (FCA, St John J), *Universal Telecasters (Qld) Ltd v Guthrie* (1978) ATPR 40-062 (FCA, Bowen CJ, Franki J and Nimmo J); *Doolan & Waltons Ltd* (1981) ATPR 40-257 (FCA, Lockhart J); *Videon v Beneficial Finance Corporation & Ors* (1981) ATPR 40-246 (FCA, Fisher J); *Walplan Pty Ltd v Wallace* (1986) ATPR 40-650 (FCA, Sweeney, Lockhart & Neaves JJ); *Wilkinson v Katies Fashions (Aust) Pty Ltd* (1986) ATPR 40-721 (FCA, Jenkinson J); *Adams v Eta Foods Limited* (1987) ATPR 40-831 (FCA, Gummow J); *Gardam v George Wills & Co Ltd (No. 1)* (1988) ATPR 40-884 (FCA, French J); *Thorpe v CA Imports Pty Limited* (1989) ATPR 40-996 (FCA, Sheppard J).

For analysis of the Trade Practices case law and its relevance to the section 1011 defence see *Golding (1993)* at 410-2 and *Golding (1997)* at 315-6. If regard is had to the factual background of those cases the very different contexts are immediately apparent.

<sup>25</sup> See section 108(1)(c) of the *Companies Code* 1981.

<sup>26</sup> The *Explanatory Memorandum* to the *Companies Bill* 1981 stated the provision is “new and provides an additional defence”(at paragraph 283).

It would appear that the defence crept into the legislation from a separate defence that had been contained in the prospectus disclosure requirements of the legislation. For some years it had been a defence to possible liability for non-compliance or a contravention of the section specifying the various matters to be set out in a prospectus if lack of knowledge or mistake was proven or in the opinion of the court the matter was immaterial or otherwise ought reasonably be excused. (See for example section 39(5) of the *Companies Act* 1961 (New South Wales), section 137(4) of the *Companies Act* 1936 (New South Wales) and section 38(4) of the *Companies Act* 1948 (England)). In other words, there was a defence based on traditional concepts of criminal exculpation.

<sup>27</sup> The *New Shorter Oxford English Dictionary* 1993, Clarendon Press defines “inadvertence” as “the quality or character of being inadvertent; inattention; carelessness; an instance of this” and “inadvertent” as “1. Of a person: not properly attentive or observant ... 2. Of an action: unintentional.”.

The *Macquarie Dictionary* 1981, Macquarie Library defines “inadvertence” as “1. the quality of being inadvertent; heedlessness. 2. an act or effect of inattention; an oversight” and “inadvertent” as “1. not attentive; heedless. 2. characterised by lack of attention, as actions, etc. 3. unintentional”.

exercised. The difficulty with the use of the term is therefore that it does not appear to require that care be undertaken by participants involved in capital raising; the threshold of liability is set at lack of knowledge rather than lack of negligence. As such, the term imposes an inconsistent requirement of behaviour to the due diligence defence.

The case law that exists in relation to the term<sup>28</sup> in analogous statutory contexts highlights this difficulty.

There is a body of case law on the use of the term “inadvertence” in these statutory contexts that establishes the term should be given its ordinary dictionary meaning. For example in *Nichol v Fearby*,<sup>29</sup> following a consideration of relevant dictionary definitions, it was said that:

“In my view the word “inadvertent” may be used according to our *jus et norma loquendi* as indicating either a negligent act, as distinguished from a careful act, or as indicating an unintentional, as distinguished from an intentional act. So, too, of an omission, as well as of an act.”<sup>30</sup>

To similar effect is the decision of *Hamilton v Property Investments Limited*<sup>31</sup> where the Supreme Court of Western Australia, held that the primary meaning of “inadvertent” is to be “not properly attentive”.<sup>32</sup>

What the case law does indicate is that the concept of inadvertence did not sit comfortably within the formulation of a desirable regulatory regime for criminal liability in the prospectus context.

*Part Only Naming Defence* - Section 1010 of the *Corporations Law* provided that an expert or advisor who was “named in part only” of a prospectus would not be liable for a misstatement if it was proved that the statement was not included in or omitted from that part of the prospectus or was not included in the form and context that the person had agreed to. However, for the

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<sup>28</sup> The concept of “inadvertence” is a feature of many statutes, both penal and civil, as a defence to liability or an ameliorating circumstance that a court may have regard to in imposing appropriate penalties. For example in the *Corporations Act* “inadvertence” is recognised in section 606(5) and section 274. As demonstrated by those provisions the concept of inadvertence is frequently grouped with concepts such as lack of knowledge, mistake or accident. Such additional terms were not included in section 996(2)(c), although the legislative background suggests a similar genesis.

<sup>29</sup> *Nichol v Fearby; Nichol v Robinson* [1923] 1 KB 480. The case related to failure to file a prescribed return following a municipal election. The relevant statutory defence extended to “illness or absence ... or by reason of inadvertence or of any other reasonable cause of a like nature and not by reason of any want of good faith”.

McCardie J in *Nichol v Fearby* suggests that when used in different legislation inadvertence should, if possible, be construed in the same way (at 499).

<sup>30</sup> *Ibid* at page 497.

<sup>31</sup> *Hamilton v Property Investments Ltd* [1983] WAR 317. The case related to the predecessor to section 606(5) of the *Corporations Act*.

<sup>32</sup> *Ibid* at 320. For a more detailed review of the case law and the issues that arise see *Golding (1997)* at 317 - 320.

limitation to be operative, the prospectus needed to include an express statement that the advisor was involved only in the preparation of that part of the document (Section 1010(2)).

The concept of being “named in part only” of a prospectus was inherently ambiguous. Previous legislation provided no section analogous to Section 1010. The legislation provided no guidance as to what was precisely intended.<sup>33</sup> For example, there was nothing in the section that prohibited the person from stating that it was not named in any part of the prospectus, even where the person was responsible for the preparation of part of the prospectus for the issuer. As such, the section could operate as a form of de-factor disclaimer. Indeed, the practice became widespread for advisors to do just that.<sup>34</sup>

The defence reflected a poor grounding in policy because it is inappropriate for a person to be able to resist liability through a form of disclaimer. The legislation should not permit persons to opt-in or opt-out of liability. While the issue of advisor liability was controversial at the time of enactment of the *Corporations Law*,<sup>35</sup> that concern should be addressed at the policy level by defining the extent of liability and the standard of care expected of the advisor.

*Knowledge Defence (Section 1007)* - Section 1007 of the *Corporations Law* provided that a person facing primary liability would not have liability to a defendant as a result of a misstatement if it was proved that when the investor subscribed for the securities to which the prospectus relates, that person knew of the misstatement.

Previous companies legislation contained no provision analogous to Section 1007.<sup>36</sup>

The requirements of *CL* Section 1007 appeared superfluous in the context of civil liability under the prospectus laws. A fundamental requirement of the civil liability regime in the prospectus context is that the investor must suffer loss as a consequence of the prospectus misstatement. If the requirements of Section 1007 were established, clearly no loss would have been caused by the misstatement in question because the investor would not have acted on that misstatement.

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<sup>33</sup> The Explanatory Memorandum to the *Corporations Bill* 1988 was silent as to the perceived reasons for introducing the defence.

<sup>34</sup> An ongoing (and unresolved) debate continued as to whether an underwriter who was involved in the preparation of a prospectus could effectively disclaim liability using section 1010. It was rare for an underwriter to attempt to do so having regard to the perception that such an attempt to exclude liability was inappropriate.

<sup>35</sup> See the discussion at Chapter 9.

<sup>36</sup> The Explanatory Memorandum to the *Corporations Bill* 1988 gave no meaningful explanation for the inclusion of the provision. See paragraph 2998 of Explanatory Memorandum to *Corporations Bill* 1988 - the paragraph merely restated the wording of the section. The wording has a similarity to the traditional equal knowledge defence that applies to Australia's insider trading laws - section 1002T of the *Corporations Act* (from 11 March 2002, section 1043M(2) of the *Corporations Act*). That, of course, is relevant to both criminal prosecutions and civil proceedings for breach of those laws.

### CLERP Act Proposals

The above analysis illustrates a poorly structured set of defences. There would appear to have been little attempt to consider the policy objectives that should apply to the formulation of the due diligence defences. There would appear to have been little consideration of how defences drawn from other sources would likely be interpreted and whether that was appropriate in the prospectus context. The overall regime had an ad-hoc flavour to them. The result gave rise to a pressing need to clarify and simplify the due diligence defences of the *Corporations Law*.

That was recognised by the *Simplification Task Force*. It commented as follows on the defences.

“These defences are based upon previous provisions of the former Companies Codes and liability provisions of Part VI of the Trade Practices Act. They have been criticised as lacking coherence and a clear underlying policy ..... These difficulties will be addressed by providing a common defence for all persons who are potentially liable in relation to prospectuses.”<sup>37</sup>

The proposals was therefore a common due diligence defence based on the traditional formulation, a defence for reasonable reliance on a statement or report supplied by another person included in the prospectus with their consent and a defence if the person withdraws their consent to be named.<sup>38</sup>

These views and proposals were again reflected by proposals in the *CLERP Fundraising Paper*.<sup>39</sup> It was suggested that:

“the same defence to a damages action would assist in ensuring a simple, comprehensive and uniform set of rules applying to those primarily involved in the preparation of a prospectus. This in turn will reduce compliance costs, in particular the legal costs of advising on due diligence responsibilities”.

The Explanatory Memorandum to the *CLERP Bill* expressed the same sentiments.<sup>40</sup>

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<sup>37</sup> *Simplification Task Force Report on Fundraising* at 16.

<sup>38</sup> *Simplification Task Force Report on Fundraising*, proposal 26.

A similar simplification had been undertaken by the Eggleston Committee in 1971. See Company Law Advisory Committee to the Standing Committee of Attorney's General “*Fifth Interim Report October 1970 on the Control of Fundraising, Share Capital and Debentures*” (Parliamentary Paper No. 99, 1971) at Appendix A proposed section 46 which proposed a simple defence of “reasonable grounds”. That would seem to be a useful telescoping of the due diligence defences. Similarly, the *Corporations and Securities Bill* 1974 had proposed consistent defences for criminal and civil liability broadly based on the Eggleston Committee proposal (section 171 (8)).

Unfortunately, this material seems to have been overlooked in the formulation of the initial *Corporations Law* and the *CLERP Act*.

<sup>39</sup> Proposal No. 15 at page 50 of the *CLERP Fundraising Paper*.

<sup>40</sup> See the similar sentiments as to the Pre-*CLERP Act* position reflected at paragraph 8.36 - 8.43 of the Explanatory Memorandum to the *CLERP Bill*.

Having regard to the above analysis of the initial *CL* provisions the commentary of the *Simplification Task Force* and the *CLERP Act* proposals were clearly a correct step.

## Chapter 6D

Chapter 6D provides for the due diligence, reasonable reliance and withdrawal of consent defences first proposed by the *Simplification Task Force*.

In addition, a special lack of knowledge defence applies to offer information statements and profile statements only.

A number of general observations can be made in relation to the Chapter 6D defences. However detailed analysis of the practical scope of the defences is deferred to Chapters 7, 8 and 9, where the defences will be tested by reference to their impact on the various participants involved in the capital raising process.

### Traditional Defence

It is appropriate that the general due diligence mirrors the traditional due diligence defence. That has been the standard of inquiry adopted since the *1890 Directors Liability Act* and is consistent with the standard of inquiry applying in the leading comparative jurisdictions. The analysis in the following chapters will demonstrate that the case law has not found the standard of inquiry to be wanting in meeting the policy objectives of the legislation.

The primary issue with the terms of the defence is that the continuing reference to “(if any)” in its requirement as to the inquiries to be made suggests that a failure to make any inquiries may be acceptable inquiries in some circumstances so as to establish the due diligence defence. It was because of this possible argument that the reference was removed from the United States test.<sup>41</sup> Similar suggestions for its removal have been made in the English context.<sup>42</sup> It should similarly be removed in Australia. As a matter of policy, it should not be considered acceptable that no inquiry could result in the defence being established.

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<sup>41</sup> See *Folk I (1969)* at 31-2.

<sup>42</sup> See *Turner (1989)* at 109 (“It is difficult to determine when such a situation could arise and the bracketed phrase therefore leaves a taste of vagueness”).

### Reasonable Reliance Defence

The new reasonable reliance defence of *CA* section 733 sits oddly in the structure of the defences. Concepts of delegation of inquiry and reliance have always been a feature of the way in which directors and other participants in the capital raising process have undertaken inquiries to establish the traditional due diligence defences. That clearly comes from the assessment of the case law in Chapters 7 and 8. On this basis introducing a separate defence for reliance is unnecessary and runs the risk of suggesting that different considerations of reliance and delegation may apply to that described in the case law.

The reasonable reliance defence can be expected to cover some of the same ground as the historic expertisation defence.<sup>43</sup> The defence was said in the background materials to have been formulated based on the view that relevant knowledge of all aspects of a disclosure document will not necessarily be within the expertise of all persons who may be potentially liable for a misstatement in the disclosure document so that a reasonable reliance defence would be appropriate in these circumstances.<sup>44</sup>

The traditional expertisation defence was an especially generous acceptance of the reliance concept in that, once the competence of the expert was established, reliance would be permitted.<sup>45</sup> A theoretical policy issue arises as to whether that generosity is appropriate.

Clearly the reasonable reliance defence in *CA* section 733 operates differently to the traditional expertisation defence. There is no explicit acceptance that, for example, if competence is established the director can rely on the work product of a person referred to in section 733 without further inquiry.<sup>46</sup> It may be that a court may draw that conclusion through the generality of the terminology of “reasonable reliance” but that cannot (and should not safely) be assumed. Therefore the reasonable reliance defence may be more demanding than the traditional expertisation defence.

Second, the reasonable reliance defence can have a broader potential scope than the traditional expertisation defence. The traditional expertisation defence permitted reliance on specified statements made by or on the authority of an expert, who was required to formally consent to the

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<sup>43</sup> No specific reason is given in the explanatory materials to the *CLERP Act* for the removal of the expertisation defence.

<sup>44</sup> See paragraph 8.39 of the Explanatory Memorandum to the *CLERP Bill*.

<sup>45</sup> See the original formulation at text accompany footnote 4.

<sup>46</sup> See the analysis in Chapter 7. The general law liability of a director for statements made by an expert is addressed *In re Pacaya Rubber and Produce Company, Limited: Burns' Application* [1914] 1 Ch 542 and the cases referred to there.

inclusion of those statements in the prospectus. For these purposes the expert was a person whose “profession or reputation gives authority” to the statements made by the expert. On the other hand, the reasonable reliance defence extends to “information given” by “another person”. The result is that the reasonable reliance does not simply extend to statements made by the other person in the disclosure document. The reliance can extend to any information given. Further, the other person need not be an expert within the previous definition.

This analysis suggests that the legislative process by which the reasonable reliance defence was developed had not clearly identified the policy goals that it had sought to achieve and suggests that there was not a clear understanding of the intended interaction between the traditional due diligence defence and the reasonable reliance defence. Each of the *Simplification Task Force* and *CLERP Fundraising Paper* treated the expertisation defence as part of the *Corporations Law* regime that could be removed through simplification. In doing so its historical relevance would not appear to have been the subject of careful consideration.

Removal of an explicit role for an expert, as compared to other persons involved in prospectus preparation, seems undesirable from a policy perspective because any relaxation of the level of reliance contemplated by the traditional due diligence should be predicated on the person being relied upon having special skills that supports an appropriate relaxation of inquiry standards for the other persons relying on that conduct. The degree (if any) of any relaxation is not apparent in the drafting of section 733.

Further, as identified by the Cohen committee in 1945, the quid pro quo for relaxed standards of reliance should be the imposition of an appropriate degree of potential liability imposed on the party being relied upon.<sup>47</sup> Under the previous regimes there was clearly defined circle of liability for statements made by an expert where there was a relaxation of liability once the credibility of the expert was established through the expertisation defence while, for the expert, reasonable inquiries were required to be established in relation to its work product for it to have a defence.<sup>48</sup> Under the contours of the *Corporations Act* the extent of the reasonable reliance defence is unclear, with liability for the person being relied upon also not clear and not necessarily matched. This is because liability under section 729 extends to named persons making a statement in the prospectus or upon which a statement is based. This contrasts to the different terminology of the defence of “information given” by “another person”. The scheme of legislation therefore seems poorly targeted.

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<sup>47</sup> See text at footnote 83 of Chapter 1.

<sup>48</sup> See the previous section 1009(3)(c).

Further, the drafting of the defence is flawed in that its requirements undermines its potential availability when applied to the procedures that are adopted in prospectus preparation. The reasonable reliance defence does not permit reliance on an “employee” or “agent” of the person and also, in the case of a body, to a “director”.<sup>49</sup> This restriction comes from the previous section 1011, which itself was based on section 85 of the *Trade Practices Act*. Those terms are likely to be given their general law meanings of controlled employment and authorisation to act on behalf of another.<sup>50</sup>

By way of example, while employees of the issuer will not be considered employees of the issuer’s directors<sup>51</sup> the position of agency in relation to the prospectus preparation process is more problematic. As discussed in Section 4.4, the due diligence committee structure contemplates a delegation of inquiry functions by the board of the issuer to the committee, with the committee delegating specified inquiry functions to appropriate professionals. Having regard to principles of delegation and reliance, from a policy perspective there is nothing offensive in structuring inquiries in that way and having the directors and others rely on that process. However, the breadth of the concept of agency results in uncertainty as to the availability of the reasonable reliance to the director in these circumstances. The director (and others) should be entitled to clarity on this issue.

As will be discussed in the later chapters it is the reasonableness of reliance that is critical, not the legal relationship between the parties. As such, the continued slavish adherence to models of regulation used in other contexts diminishes the effectiveness of the statutory provisions (as was the case with the previous section 1011).

Having regard to the above analysis a much more effective approach to regulation would have been to retain the previous expertisation defence in section 733 and to explicitly provide for expert liability in section 729.

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<sup>49</sup> Section 733(1)(a) and (b) . A person is not an agent for these purposes merely because they perform a particular professional or advisory function (s. 733(2)).

<sup>50</sup> For the definition of employee see for example the analysis in Fleming “*The Law of Torts*” 8th Edition, 1992, Law Book Company at 369-376 and for the definition of agent see for example the analysis in Trietal “*The Law of Contract*” 8th Edition, 1991, Stevens and the cases referred to there.

<sup>51</sup> The explanatory memorandum to the *CLERP Bill* makes it clear that the proposed limitation will not preclude a director replying on information supplied by the issuer’s employees as those persons are not employees of the director - at paragraph 8.41.

### Withdrawal Defence

The withdrawal defences fail to provide possible grounds for exculpation for a director that discovers a deficiency with a disclosure document. The defence is limited to persons who are proposed directors or underwriters or who make a statement in the prospectus (or a statement on which a statement is based). The defence requires a public withdrawal of consent.

Traditionally, a director could establish a defence if a deficiency was identified by the director and the director withdrew their consent to act. Under the *pre-CLERP Corporations Law* a director who had not consented to the issue of the prospectus had a defence if they give reasonable public notice that they had not consented as soon as practicable after its issue. This defence was poorly formulated as applied to an existing director (as compared to a proposed director) because a prospectus could not in fact be issued without the directors signature (signifying consent).<sup>52</sup>

On the other hand, a defence was available to the director if, after issue of the prospectus, they became aware of a misstatement, withdrew their consent, and gave reasonable public notice of the withdrawal and the reasons for doing so.<sup>53</sup> This defence had a long history before the enactment of the *Corporations Law*<sup>54</sup> and is consistent with the withdrawal defence in other key jurisdictions.<sup>55</sup> To give no withdrawal defence for a director who discovers a misstatement does not seem sound as a matter of policy as there is no incentive for the director to make disclosure in this type of situation.<sup>56</sup>

### Lack of Knowledge Defence

The lack of knowledge defences give rise to significantly reduced inquiry obligations in the case of an offer information statement or profile statement. This defence provides that if the person did not know that there was a misstatement in the disclosure document, liability will not arise. While a more detailed analysis of this defence is deferred to section 6.2 where it is considered in the context of the offer information statement (and profile statement) it is surprising at a policy level that a defence of this nature was proposed.

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<sup>52</sup> Section 1021(13) of the *Corporations Law*.

<sup>53</sup> Section 1008(4) of the *Corporations Law*.

<sup>54</sup> See for example section 107(5) of the *Companies Code* 1981.

<sup>55</sup> See section 11(b)(2) of the *Securities Act* 1933 which requires reasonable public notice as well as advice to the SEC.

<sup>56</sup> Notwithstanding this proposition the likelihood of the withdrawal defence being used in practice is slight because of the dramatic publicity consequences of such a unilateral step by a director.

The policy underpinning of the prospectus laws since the enactment of the 1890 *Directors Liability Act* following the decision in *Derry v Peek* was to require due care on the part of those involved in prospectus preparation. Imposing an actual knowledge requirement for misstatement liability imposes a culpability regime that is analogous to the tort of deceit, the very standard the legislative regime was introduced to overcome.

#### 4.2 COMPARATIVE ANALYSIS WITH OTHER KEY JURISDICTIONS

It is helpful to contrast the Australian position with the due diligence defences available in other key jurisdictions. A brief survey of these provisions further illustrates the desirability of moving from the disparate and ambiguous defences of the original *Corporations Law* to the simplified defences following the *CLERP Act*. However, it again raises the issue of why a comparative analysis of other jurisdictions did not suggest the desirability of the inclusion of an expertisation defence as compared to the reasonable reliance defence.

##### United Kingdom Position

Under the *Financial Services and Markets Act 2000* and *The Public Offers of Securities Regulations 1995* there are a variety of consent based and due diligence based defences available to all persons with primary liability to pay compensation.<sup>57</sup>

The due diligence defence is expressed in traditional terms:

“if he satisfies the court that ..... he reasonably believed having made such enquiries, if any, as were reasonable that the statement was true and not misleading or that the matter whose omission caused a loss was properly omitted”<sup>58</sup>

The person must also satisfy the court as to one of four conditions being that he continued in that belief until the time the securities in question were acquired, the securities were acquired before it was reasonably practicable to bring a correction to the attention of persons likely to acquire them, before the securities had been acquired he had taken all steps as it was reasonable for him to have taken to secure a correction was brought to the attention of those persons or he continued in his belief until after the commencement of dealings in the securities on the stock exchange and they

<sup>57</sup> Schedule 10 the *Financial Services and Markets Act 2000*. The regime is replicated for unlisted securities in regulations 13 to 15 of the *Public Offers of Securities Regulations 1995*.

<sup>58</sup> Paragraph 1(2) of Schedule 10 to the *Financial Services and Markets Act 2000*. It is necessary to prove that that belief continued until the securities were acquired, they were acquired before it was reasonably practical for the misstatement to be corrected and all reasonable steps were taken to bring the misstatement to the attention of the person or the belief continued until the security were quoted and the securities were acquired after such a lapse of time that the person should be reasonably excused.

were acquired after such a lapse of time that he ought in the circumstances be reasonably excused.<sup>59</sup>

The expertisation defence is available for statements made by experts and statements extracted from public official documents. For an expert it is necessary to establish belief in the competency of the expert.<sup>60</sup>

“he satisfies the court that . . . . . he reasonably believed that the other person (a) was competent to make or authorise the statement”.

Again, this defence is subject to one of the four conditions specified above.<sup>61</sup>

### **United States Position**

The United States legislation is based on the English antecedents and contains various consent based and enquiry based defences from liability for the persons involved in the capital raising process (except the issuer).

The due diligence defence in section 11 is expressed as being:

“after reasonable investigation, had reasonable grounds to believe and did believe, at the time such part of the registration became effective that the statements therein were true and that there was no omission.”<sup>62</sup>

The critical distinction between the United Kingdom and Australian formulation of the defence, and the United States formulation of the defence is the different terminology of reasonable inquiry versus reasonable investigation. Nothing would seem to turn on that distinction. The significance of the deletion of the words “if any” that appear in the United Kingdom and Australian defences has been noted above. In other respects the structure of the defences are almost identical.

An important distinction between the United States legislation and other jurisdictions is that the due diligence defences include a definition of the standard of reasonableness that is required, which is expressed in the following terms:

“What constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property”.<sup>63</sup>

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<sup>59</sup> Paragraph 1(3) of Schedule 10 the *Financial Services and Markets Act 2000*.

<sup>60</sup> Paragraph 2(2) of Schedule 10 to the *Financial Services and Markets Act 2000*.

<sup>61</sup> Paragraph 2(3) of Schedule 10 to the *Financial Services and Markets Act 2000*.

<sup>62</sup> Section 11(b)(3)(A).

While the SEC has promulgated guidelines on interpreting the requirements of due diligence,<sup>64</sup> the generality and ambiguity of the standards provide little practical guidance.<sup>65</sup>

The expertisation defences are available for statements made by experts and statements extracted from public official documents. For an expert it is necessary to establish:

“he had no reasonable ground to believe, and did not believe ..... such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy or extract from the report or valuation of the expert.”<sup>66</sup>

The United States expertisation defence therefore differs from the United Kingdom defence in that in the United States all that is required is a fair representation of the statement while in the United Kingdom the person must also establish their belief in the competency of the expert. This significant distinction is the subject of further analysis in Section 7.3.

The second expertisation defence available in relation to statements made by an “official person” or based on a “public official document” is in the same terms as the first expertisation defence.<sup>67</sup>

Section 12(2) contains an abbreviated formulation of a due diligence defence.<sup>68</sup> It is generally accepted in the United States that a similar approach should be adopted to the application of the section 12(2) due diligence defence as compared to the section 11 due diligence defence.<sup>69</sup>

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<sup>63</sup> Section 11(c) of *Securities Act 1933*.

<sup>64</sup> Rule 176 promulgated under the *Securities Act 1933*. Rule 176 provides that:

“In determining whether or not the conduct of a person constitutes a reasonable investigation or a reasonable ground for belief meeting the standard set forth in Section 11(c), relevant circumstances include, with respect to a person other than the issuer:

- (a) The type of issuer;
- (b) The type of security;
- (c) The type of person;
- (d) The office held when the person is an officer;
- (e) The presence or absence of another relationship to the issuer when the person is a director or proposed director;
- (f) Reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in light of the functions and responsibilities of the particular person with respect to the issuer and the filing);
- (g) When the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registration; and
- (h) Whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated.”

<sup>65</sup> See for example *Note (1983)* at 784; *Frerichs (1985)* at 399-401.

<sup>66</sup> Section 11(b)(3)(C).

<sup>67</sup> Section 11(b)(3)(D).

<sup>68</sup> The defence allows relief from liability for a “seller” of securities who shall:

As has been noted in Chapter 3, the Canadian legislation tends to be almost identical to the United States models on which it is based, including in relation to expertisation.<sup>70</sup>

### 4.3 ANALOGY TO NEGLIGENCE

When the criminal liability provisions, civil liability provisions and due diligence defences are set out in full, the question arises as to the general standard of culpability that is established for liability purposes through the statutory provisions. This is an important issue to address for policy analysis so as to contrast the *Corporations Act* regime to other available remedies.

The material clearly establishes that the *Corporations Act* regime should be considered as analogous to the standard of conduct required by the tort of negligence for those who face potential primary liability.

In the United States context there is a large body of material in support of that position. The best illustration is the Supreme Court decision in *Ernst & Ernst v Hochfelder*<sup>71</sup> where the court considered the standard of culpability that should apply under Rule 10b-5. The Court said that a contrast should apply to the standard of culpability imposed on persons with liability under section 11 (other than the issuer) where such persons:

“are accorded a “due diligence” defence. In effect, this is a negligence standard ... The express recognition of a cause of action premised on negligent behaviour in section 11 stands in sharp contrast to the language of section 10(b).”<sup>72</sup>

Similar observations have been made in analogous contexts by Australian/English courts. In *Tesco Supermarkets Limited v Natrass*<sup>73</sup> it was said that a due diligence defence is the converse of

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“sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission”.

<sup>69</sup> See *Sanders v John Nuveen & Co* 619 F 2d 1222 (9th Cir 1980); *Weinberger v Jackson, et al* [1990 Transfer Binder] CCH Fed See L Rep 95,693 at 98,255.

<sup>70</sup> See for example section 128 of the *Securities Act* (Ontario).

<sup>71</sup> 425 US 185 (1976).

<sup>72</sup> See also the *BarChris Case*.

<sup>73</sup> [1972] AC 153. The case involved a prosecution under the UK Trade Descriptions Act 1968 which involved a defence of “all reasonable precautions” and “due diligence”.

negligence.<sup>74</sup> This observation has been echoed in Australia in relation to environmental liability laws where a due diligence defence has been equated with an absence of negligence.<sup>75</sup>

This is an important preliminary observation because when the *Corporations Act* liability regime is assessed in these terms it can be seen that at the most basic level the due diligence defence requires a participant involved in the capital raising process to meet expectations of reasonable behaviour for such persons.<sup>76</sup>

This conclusion also follows from the case law analysis set out in Chapters 7, 8 and 9. In each case reasonable inquiries are to be tested by reference to the inquiries that a reasonable person of that type would be expected to undertake in the relevant circumstances.

#### 4.4 PRACTICES ADOPTED IN AUSTRALIA TO MINIMISE LIABILITY

The enactment of the *Corporations Law* prospectus provisions led to significant changes in the procedures adopted in the preparation of offering documents in Australia. Those practices are also quite different to the practices adopted in other key jurisdictions, particularly the committee structure described below.<sup>77</sup>

It is helpful to describe current practices in the context of this dissertation so that those practices can be assessed in the following Chapters by reference to the position of the different categories of persons involved in the capital raising process so as to determine if they achieve their objective of risk minimisation and to determine whether the benefits associated with those practices outweigh the costs associated with them. This is an important objective, having regard to the frequent criticism as to the costs associated with fundraising, which was a key consideration in developing the reforms contained in the *CLERP Act*.<sup>78</sup> In addition, there has been little documentation in the academic literature of the due diligence procedures that are adopted in Australia.<sup>79</sup>

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<sup>74</sup> Ibid at 199 (Lord Diplock). See also *Riverstone Meat Co Pty Ltd v Lancashire Shipping Co Ltd* [1960] 1 All ER 193 (due diligence equated with reasonable care) and *Maxine Footwear Co Ltd v Canadian Government Merchant Marine Ltd* [1959] AC 589 (absence of due diligence equated with negligence).

<sup>75</sup> See *Australian Iron & Steel Pty Ltd v Environmental Protection Authority* (1992) 29 NSWLR 497 (Court of Criminal Appeal) at 510 (Abadee J) also citing as authority for that proposition *He Kaw Teh v The Queen* [1984-5] 157 CLR 523 and the Canadian case of *R v City of Sault Ste Marie* [1978] 85 DLR (3d) 161.

<sup>76</sup> See *Fox* (1984) at 1031 citing L Loss “*Securities Regulation*” 2nd ed, 1961 at 1729-30.

<sup>77</sup> The following description is based on the authors’ experience as a practitioner in this area of the practice of law.

<sup>78</sup> See text accompanying footnotes 217 and 218 of Chapter 1.

<sup>79</sup> Journal articles describing Australian practices include *Golding* (1993) at 402-4 and S. Minns & G. Golding “*Prospectus Due Diligence: A Focused Approach*” (1993) 11 C&SLJ 542. See also *Earp & McGrath* (1995) at 71-8; A. Hood & D. Boswell “*Due Diligence*

### Reasons for changed practices

The threshold issue can be posed of why it was thought necessary to alter existing practices with the enactment of the *Corporations Law*. After all, civil liability with due diligence defences had been a feature of Australia's securities laws for most of the last century. The reasons for the shift in attitude are likely to have related to the move to a more ambiguous disclosure criteria as described in Chapter 6 and the imposition of liability on a broader range of participants in the capital raising process.

In addition, the perceived role of the regulator significantly altered. Under the *Companies Code 1981* the Corporate Affairs Commission of each state would not register an offering document unless its officers were satisfied that the disclosure in the document addressed each item in a checklist of disclosure items set out in the companies legislation. Therefore, participants in the capital raising such as underwriters would not tend to independently verify disclosures because of the perceived safety-net of regulatory review. This was particularly so when those persons were not specifically identified as having primary liability for the prospectus.

From the outset following the enactment of the *Corporations Law* ASIC indicated that it would not assist issuers and other participants in the capital raising process in determining the adequacy of prospectus disclosure items and that it would not undertake a detailed review of offering documents in the period prior to registration of the offering document.<sup>80</sup>

### Initial development of the checklist/committee approach

A practice of due diligence inquiries soon developed focusing around the use of checklists and committees. The initial reaction of the business community as participants in the capital raising process was to focus very closely, perhaps to an inappropriate degree, on their potential liability as participants in the capital raising process.

The response of the professional services market to those concerns was to develop defensive procedures designed to maximise the availability of the due diligence defences to each person involved in the capital raising process.

The defensive procedures can be summarised as follows:

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*Reviews for Fundraisings under the Australian Corporations Law* Chapter 11 in G. Walker (ed) *Securities Regulation in Australia and New Zealand* 1998, Second Edition, Law Book Company.

<sup>80</sup> ASIC Policy Statement 2 issued 26 April 1991, now superseded.

### **Due Diligence Committee**

A due diligence committee is established by the board of the issuer to supervise and make decisions concerning the conduct of enquiries to ensure that there will be no misstatements in the disclosure document and to supervise the preparation of the disclosure document. The due diligence committee will generally comprise a representative of each person that may have primary civil liability under the *Corporations Act*. The due diligence committee will include representatives of the non-executive directors of the issuers, the executive directors of the issuer, the underwriter, the issuer's lawyer, the issuer's accountants and (in some cases) the underwriter's lawyer.

The due diligence committee reports to the board of the issuer. The board will rely on the work of the due diligence committee to consent to the issue of the prospectus and to seek to establish the issuer and director due diligence defences in the *Corporations Act*. The other participants in the capital raising process will also rely on the work of the due diligence committee to seek to establish their own defences.

An important reason for the development of the committee structure was to provide a facility whereby enquiries could be conducted by each participant involved in the capital raising on an "integrated" basis. The perception was that if this committee structure had not been developed each participant would wish to conduct detailed enquiries, leading to duplication of enquiries and needless expense.

### **Conduct of enquiries**

The due diligence committee structure involves the delegation of enquiry functions by each person involved in preparation of the disclosure document to persons appointed by the due diligence committee. Typically the division of responsibility for inquiries is as follows:

- for matters involving the issuer and its organisation - designated executives of the issuer;
- for financial matters - the accountants to the issuer; and
- for legal matters - legal advisers to the issuer.

### Scope of inquiries and checklists

In the initial years following the enactment of the *Corporations Law*, there was a fixation on the process of conducting due diligence enquiries through the road map of formal checklists.<sup>81</sup>

The standard model for these enquiries was the checklist prepared by the Securities Institute of Australia, first published in 1991. The reason for the use of the checklist was said to be to ensure that participants focus on the broad range of enquiries that are relevant in a capital raising. In addition, it was considered that the introduction of standards would serve to identify objective criteria by which the reasonableness of enquiry could be established.

A likely reason for the initial attractiveness of the checklist approach was the absence of clear legislative guidance as to the contents of prospectuses. With the loss of the disclosure checklist set out in the legislation, it is likely that persons involved in prospectus preparation felt some comfort from the preparation of an analogous list so as to guide their enquiries. However, a checklist is only of indirect benefit as it does not focus on disclosure items but instead on enquiries to be undertaken so as to minimise the liability that may arise.

Following initial reliance on checklist based enquiries, a gradual change in emphasis developed.<sup>82</sup> A number of difficulties with long checklists were identified. The checklist often seemed settled without any real understanding of the issuer and its business. Equal prominence and priority was given to all items identified in the checklist.

For this reason, the checklist tended to lack focus and failed to prioritise the key risk areas to be identified through the enquiries. The resultant enquiries were perceived to be excessively time consuming and overlooked the real issues confronting the issuer and its business. The mass of material produced on trivial matters involved a risk that attention to detail would be lost on critical issues.

The net result was that there was a concern that enquiries tended to be very much a case of form over substance, timetables were excessive and there was perceived to be a significant blow out in the costs of capital raising.

The high water mark of these concerns in the early years following the enactment of the *Corporations Law* surfaced with the initial public offering of GIO Australia Limited, where the

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<sup>81</sup> See for example E. Varejes “Section 1011(1) of the *Corporations Law*: Guidance for Sponsoring Brokers and Underwriters extracted from the *American Experience*” (1991) Butterworths Corp Law Bulletin at para 114.

<sup>82</sup> For analysis see Note (S. Minns & G Golding) *supra*.

managing director of that company was moved to say following the successful completion of the float, that he:

“would gladly have “burned” sections of the prospectus and would have conducted the whole issue differently.”<sup>83</sup>

From these criticisms developed an alternative approach to enquiries based on the identification of key issues and prioritisation of enquiry functions. Due diligence enquiries were instead initially directed to the identification of key issues to allow those involved in prospectus preparation to properly understand risk factors as soon as possible and to lead to an earlier settlement of the key issues to guide the prospectus preparation process.

Under the issues-driven due diligence prospectus preparation process three main stages of enquiry are involved:

- initial scoping review;
- detailed enquiry processes; and
- verification.

The initial scoping review is designed around the following:

- interviews by the due diligence committee with senior and divisional management to discuss historic performance, past problem areas, budgeting experience, internal reporting systems, strength, weaknesses, opportunities, threats and financial projections;
- interview with auditors to discuss applicable accounting principles, audit history and audit issues; and
- review of organisational structure, management authorities and internal procedures.

As a consequence of the scoping review, an issues memorandum is typically approved and presented to the board of the issuer containing a list of preliminary issues agreed by the due diligence committee as appropriate for further inquiries. Professional advisers are required at this point to submit detailed work programs on the issues for which they will be responsible in those second stage inquiries.

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<sup>83</sup> Business Review Weekly, “What Went Wrong With the GIO Float?” 28 August 1992 at page 46.

Based on the work conducted by the due diligence committee in formulating the issues memorandum, the prospectus and its disclosures are then prepared in conjunction with detailed due diligence enquiries on the identified key issues.

The relevant focus during this stage is on the following areas:

- Prospectus preparation - drafts of the disclosure document are prepared based on the scoping review. In preparing the disclosure document, attention is given to the key areas of risk identified in the scoping review.
- Expert reporting - reports are received by the due diligence committee based on the approved work programs settled with the experts and professional advisers.
- Issues analysis - as issues arise (either from the scoping review or subsequent work) they are assessed and resolved<sup>84</sup> through issues reports considered by the due diligence committee. Management questionnaires are frequently used in this area.
- Internal reporting systems - periodic reports from management generated by the internal reporting system are modified to report specifically on the disclosure criteria in the prospectus so as to draw attention to any matter that has arisen which bears upon these issues.

### **Verification**

As the prospectus is prepared, material statements are verified by persons delegated that responsibility by the due diligence committee. Verification is a process of confirmation to ensure appropriate supporting material is available to establish the accuracy of statements made in the prospectus. To the maximum extent available, verification material will be external objective data confirming the veracity of disclosure, as distinct from confirmation by management that the disclosure is correct.

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<sup>84</sup> An issue can be resolved in one of 3 ways for purposes of the offering:

- Full and fair disclosure of the matter can be made in the disclosure document.
- A determination can be made by the due diligence committee and the directors that the issue is not material for purposes of disclosure.
- The offer can be withdrawn.

### Sign-offs

Immediately prior to the approval of the prospectus by the directors of the issuer a series of sign-offs will be received.

Each senior officer of the issuer will deliver a certificate confirming that the officer does not believe that there is a misstatement or omission in the prospectus in relation to his/her area of responsibility.

The issuer's lawyer will deliver an opinion in relation to the prospectus. On the issue of disclosure the legal opinion will customarily confirm that nothing has come to the attention of the lawyer that causes them to believe (ie an opinion in the form of a negative assurance) that there is a material misstatement or omission in the prospectus. On the issue of enquiries the opinion will confirm that the lawyer believes that the due diligence enquiries have been conducted in accordance with the due diligence planning memorandum. Further the opinion will give a negative assurance that nothing causes the lawyer to believe that the enquiries do not constitute reasonable grounds and reasonable belief by the directors that there is no misstatement in the prospectus.

The investigating accountant will deliver a variety of advices. It remains the custom in Australia for an investigating accountant's report to be included in the prospectus. An investigating accountant's report is not an audit of relevant financial statements. It will however typically conclude that the accounts present fairly the relevant financial position disclosed in the disclosure document in accordance with relevant accounting principles.

In addition, it has become customary for the accountant to comment on any financial forecasts contained in the offering document. The opinion will normally state that nothing has come to the attention of the accountant which causes it to believe that the assumptions used in the financial forecasts do not provide a reasonable basis for the forecast, that the financial forecast is presented on a basis consistent with the accounting policies used in the historical financial statements of the issuer and that the financial forecasts give effect in all material respects to the assumptions that were used.<sup>85</sup>

Finally, the accountant will deliver a private report on the disclosures contained in the disclosure document, particularly the financial disclosures. That opinion will give a negative assurance that nothing causes the accountant to believe the prospectus contains a misstatement or omission.

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<sup>85</sup> That opinion is given in accordance with the professional guidelines set out in Australian Auditing Standard 804.

The due diligence committee, as a committee, will deliver a report to the board of the issuer confirming the various decisions that have been made by the committee. On disclosure, each member of the committee will give a negative assurance that nothing causes that member to believe that there is a misstatement or omission in the prospectus. On enquiries each member of the committee will give a negative assurance they are satisfied that the establishment and supervision of the due diligence system has been adequate to avoid any misstatement in the prospectus and to ensure that the disclosures required by the *Corporations Act* have been made.

Each member of the board of the issuer will have independently reviewed the prospectus and will review and consider the report of the due diligence committee and the other sign-offs referred to above. Following the receipt of the various formal reports and opinions the board of the issuer will consent to the issue of the prospectus.

### **Interim Arrangements**

In the period between the lodgement of the prospectus with ASIC and the allotment of the offered securities the structure of the due diligence committee will remain in place. This is to ensure that there is evidence of continuing inquiries to support decisions made in relation to the possible lodgement of a supplementary prospectus under the updating requirements of the *Corporations Act*.

### **Comparison with United States Practice**

The committee structure outlined above is quite different from the United States procedure.

In the United States, issuer inquiries and underwriter inquiries tend to be undertaken quite separately. This in part reflects the traditional specification of the issuer and its officers (on the one hand) and the underwriter (on the other) as the two parties primarily responsible for a prospectus and in part reflects the cultural changes wrought by the *BarChris Case* as described in Chapter 7 and Chapter 8.

Directors of the issuer (the issuer itself has no potential defence) conduct inquiries through the board reporting structure.

Underwriters tend to undertake structured inquiries through management question and answer sessions conducted with their own lawyers. These management presentations have, in part, been the precedent for the development of issues driven due diligence in Australia.

Other participants in the capital raising process (lawyers and accountants) proceed on the presumption that they do not have liability except for any expert reports (there tends not to be such expert reports in US documents) or as accessories, and do not undertake general inquiries except as agents for other participants.

There is also much less formal reporting and sign-off procedures in the United States than Australia.

Legal advisers to the issuer and underwriter will each deliver opinions but only on a negative assurance basis as to disclosure and not as to the existence of defences (known as “10b-5 opinions”).<sup>86</sup>

Accountants to the issuer will deliver a series of opinions as to compliance with relevant accounting standards by the historic accounting information included in the registration statement (known as “cold comfort opinions”).

While the lack of formal structure in the United States system has been the subject of criticism in its ability to defend challenges through litigation,<sup>87</sup> there has been no moves to fundamentally change inquiry practices in the United States over the last two decades.

### **Comparison with United Kingdom Practice**

In the United Kingdom due diligence practice tends to be closer to the practice adopted in Australia before the enactment of the *Corporations Law*.

In part this is a reflection of the detailed list of disclosure items set out in the Listing Rules of the UK Listing Authority. However, considerable emphasis is placed by the issuer and underwriters on detailed verification of the final prospectus. The issuer and its lawyers prepare comprehensive verification notes which will be closely reviewed by the underwriter and its legal advisor.<sup>88</sup> This procedure is the genesis of the verification procedure adopted in Australia as outlined above.

There is much less reliance on formal sign-offs in the United Kingdom than is the case in Australia.

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<sup>86</sup> For discussion see D.A. Rice & M.I. Steinberg “*Legal Opinions in Securities Transactions*” (1991) 16 *Jnl of Corp L* 375 at 381.

<sup>87</sup> See the discussion in *Spanner (1987)* and *Langevoort (2000)* at 63

<sup>88</sup> For a description of the process see *Gleeson & Bloomenthal (1999)* at 416 - 418.

## CHAPTER 5

### OVERLAPPING LIABILITY REGIMES

It is very clear that the legislative scheme encapsulated in the prospectus liability rules is not intended to be all embracing. If any guidance was required CA section 729(4) provides that:

“This Part does not affect any liability that a person has under any other law”.

This chapter identifies the key general law and statutory provisions outside the provisions of CA Part 6D.3 that are relevant to prospectus misstatement.

#### 5.1 MISLEADING & DECEPTIVE CONDUCT LIABILITY

##### Background

From humble beginnings in the consumer protection provisions of the 1974 *Trade Practices Act* a comprehensive regulatory regime providing for compensation for misleading or deceptive conduct has developed in Australia over the last two decades. That development has had far reaching consequences for a number of branches of Australian law,<sup>1</sup> including securities law. It has been argued that the jurisprudence on section 52 demonstrates not only the extension of legislative provisions on areas previously covered by general legal principles, but also a challenge to develop further general law principles to deal with deficiencies in that body of law now reflected by the more active jurisprudence of section 52.<sup>2</sup> That principle (as analysed below) has been used by Australian courts to justify any perceived concern that the scope of section 52 should extend beyond the torts of deceit and negligent misstatement to misstatements made innocently.<sup>3</sup>

The sources of the *Misleading & Deceptive Conduct Provisions* as they impact on the securities laws are now reflected in section 52 of the *Trade Practices Act*, section 12DA of the *Australian Securities & Investments Commission Act*, section 1041H of the *Corporations Act*<sup>4</sup> and the *Fair*

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<sup>1</sup> “Resorting to florid metaphor, the dedicated legal modernist may depict the common law and its causes of action as primeval broadacres grazed by slow growing sauropods. Upon this landscape the action for misleading or deceptive conduct falls as a kind of statutory comet threatening significant reduction in the species numbers of fraud, negligent misstatement, passing off, defamation, collateral warranty and contractual representation” - see *French (1989)* at 250.

<sup>2</sup> See P. Finn “*Statutes and the Common Law*” (1992) 22 *Uni WA L Rev* 7 at 11 and 25.

<sup>3</sup> See Gummow J in *Demagogue Pty Ltd v Ramensky & Anor* (1992) 39 *FCR* 31 (FCA, Black CJ, Gummow and Cooper JJ) at 37-8.

<sup>4</sup> From 11 March 2002. Prior to that time, section 995 of the *Corporations Act*.

*Trading Acts* of each State.<sup>5</sup> Each of these legislative regimes provides for civil liability to compensate an injured party in circumstances where a person “engages in conduct” that is “misleading or deceptive or is likely to mislead or deceive”. It is important to appreciate that as a general matter a contravention of the *Misleading & Deceptive Conduct Provisions* does not give rise to criminal liability.<sup>6</sup>

The remedy was initially solely set out in section 52 of the *TPA*. In the 1980s complimentary state based *Fair Trading Acts* were introduced to deal with constitutional limitations in the operation of the *TPA*. In 1991 an analogue provision was introduced into the *Corporations Law* to govern securities transactions.

In 1998 the *Trade Practices Act* and corporations legislation were amended to achieve the intention that responsibility for securities law matters be transferred from the Australian Consumer & Competition Commission to ASIC. This was achieved by introducing section 51AF of the *Trade Practices Act* and section 12AD of the *ASIC Act*.<sup>7</sup>

As such from 1 July 1998 section 12DA of the *ASIC Act* replaced *TPA* section 52 for securities law matters.<sup>8</sup>

There are a variety of limitations built into the various statutory provisions. However none of them will have the impact of seriously precluding the application of the *Misleading & Deceptive Conduct Provisions* to conduct engaged in relation to prospectuses.<sup>9</sup>

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<sup>5</sup> *Fair Trading Act* 1987 (NSW) (particularly s.62); *Fair Trading Act* 1985 (Vic) (particularly s.32); *Fair Trading Act* 1987 (W.A.) (particularly s.69); *Fair Trading Act* 1989 (Qld) (particularly s.92); *Fair Trading Act* 1987 (S.A.) (particularly s.56); *Fair Trading Act* 1990 (Tas) (particularly s.14); *Fair Trading Act* 1990 (NT) and *Fair Trading Act* 1992 (ACT).

<sup>6</sup> See section 79(1) of the *Trade Practices Act*, section 12GB(1) of the *ASIC Act* and note 1 to section 1041H(1) of the *Corporations Act*.

<sup>7</sup> *TPA* section 51AF provides that *TPA* Part V does not apply to the supply of “financial services”. Division 2 of the *ASIC Act* replicates Part V of the *ASIC Act* (with section 12DA replicating section 52) in relation to the supply of “financial services”.

Financial services are defined for these purposes as a service that consists of providing a financial product (definition in section 12BA of the *ASIC Act* and see definition in section 4 of the *TPA*).

Financial products include securities, as well as a variety of financial instruments (the definition in section 12BA of the *ASIC Act* extends to futures contracts, bank deposits, insurance policies and superannuation interests).

<sup>8</sup> Subject to technical interpretative issues as to whether a supply of financial services is involved in particular conduct that may be engaged in.

<sup>9</sup> Section 1041H is limited to conduct relating to securities (section 92 definition). Section 12DA is limited to conduct relating to financial services (section 12BAB definition). Section 52 has the constitutional limitations of conduct engaged in by a “corporation” in relation to “trade and commerce”, subject however to the extensions of applications provided for in section 6(3) of the *Trade Practices Act* (persons engaging in conduct by telephonic services); section 6(4) of the *Trade Practices Act* (persons engaging in conduct) and section 6(5) of the *Trade Practices Act* (professional persons engaged in commerce). The *Fair Trading Acts* have no such limitations.

## Standard of Conduct

The similarity between the tests for liability under the *Corporations Act* prospectus liability provisions and the *Misleading & Deceptive Conduct* provisions was discussed in Section 2.4.

However, the fundamental policy issue that arises from the *Misleading & Deceptive Conduct Provisions* jurisprudence is that Australian courts have consistently expressed the view that the legislation should not be fault based. As such, the relevant statutes have been interpreted to impose potential civil liability on a person who engages in misleading conduct, even if that conduct is innocent. The courts have refused to introduce intent limitations or negligence criteria into the requirements of the provisions:

“There is nothing in the section that would confine it to conduct which was engaged in as a result of a failure to take reasonable care. A corporation which has acted honestly and reasonably may therefore nevertheless be rendered liable to be restrained by injunction and to pay damages if its conduct has in fact misled or deceived or is likely to mislead or deceive. The liability imposed by s.52, in conjunction with ss.80 and 82, is thus quite unrelated to fault.”<sup>10</sup>

The consumer protection objectives of section 52 have clearly been strongly influential in the judicial development of the law.<sup>11</sup> As such if a deterrence objective can be identified as the primary policy underpinning of Part 6D.3 of the *Corporations Act*, some attempt might be made to distinguish section 1041H liability from section 52 of the *Trade Practices Act*.

However, the Explanatory Memorandum to the *Corporations Bill* made the following observations in relation to the then section 995:

“The provision is considered to be important in maintaining integrity in the securities market. While supporting deregulatory moves in general, the Government is concerned that investors be protected from unscrupulous activity in the securities market. ... A guide to what type of conduct is misleading or deceptive can be gained from the many cases decided under TPA s.52. The Courts have tended to give a broad meaning to the terms. It can also be noted that TPA s.52 may itself apply in some cases of securities dealing. In order to stress the undesirability of the conduct in

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<sup>10</sup> *Parkdale Custom Built Furniture Pty Ltd v Puxu Pty Ltd* (1982) 149 CLR 191 per Gibbs CJ at 197. See also, among others, *Hornsby Building Information Centre Pty Ltd v Sydney Building Information Centre Pty Ltd* (1978) 140 CLR 216 and *Yorke & Anor v Lucas* (1985) 159 CLR 661 per Brennan J at 675.

<sup>11</sup> For example in *Yorke & Anor v Lucas* (1985) 158 CLR 661 Brennan J inferred that the legislature intended that the burden of loss suffered by the “consumer” as a result of want of knowledge by a corporation should fall on the corporation (at 675). The law of sale of goods and consumer protection has had a long history of imposing strict liability.

This is very different from the historical approach of requiring culpability evidenced by the securities laws. See *Hart* (1987) at 170-1.

question it was considered important to include a similar provision to s.52 in the Bill.”<sup>12</sup>

It was therefore inevitable that Australian courts would adopt a similar approach to liability under section 12DA of the *ASIC Act* and section 1041H of the *Corporations Act* as exists under *TPA* section 52.<sup>13</sup> This is clearly confirmed by the Full Federal Court in the *NRMA Case*<sup>14</sup> where the s.52 case law was applied to the securities law context without any expressed concerns for policy underpinnings of the consumer protection focus of the *TPA* being extended to securities dealings:

“A contravention of s.52 may occur without knowledge or fault on the part of the corporation, and notwithstanding the exercise of reasonable care: *Parkdale Custom Built Furniture Pty Ltd v Puxu Pty Ltd* at CLR 197”.<sup>15</sup>

While that comment was made in relation to s.52, the court considered the application of the then section 995 of the *Corporations Act* would give the same result.<sup>16</sup>

### Omissions and Silence

The *Misleading & Deceptive Conduct Provisions* do not mandate any particular disclosure standard relevant to determining the existence of a misstatement. As such issues arise in relation to when silence or an omission will give rise to liability.

The starting point of analysis is to appreciate that at general law the tort of deceit and negligent misstatement provided that tort liability would only arise in relation to misleading statements of fact.<sup>17</sup> The consequence was that where there was silence as to a material fact no obligation to

<sup>12</sup> Explanatory Memorandum to *Corporations Bill* 1988 at paragraphs 2960-1.

<sup>13</sup> For examples of early analysis that assumes that this will be so see *Austin (1989)* at 115; *Azzi (1991)* at 229.

<sup>14</sup> *Fraser & Anor v NRMA Holdings Limited & Ors* (1994) 14 ACSR 656 (Gummow J) and (1995) 15 ACSR 590 (Full Federal Court), an action commenced by dissident directors of an entity associated with the issuer of securities alleging that a document that comprised a notice of meeting for the demutualisation of NRMA Holdings Ltd and also a prospectus for the listing of NRMA Holdings Pty Limited, was misleading and deceptive.

<sup>15</sup> *Ibid* at 603. To similar effect see the subsequent case brought by NRMA against its advisers - *NRMA Ltd & Ors v Morgan & Ors* (1999) 31 ACSR 435 (SC NSW, Giles J) at 787. See also *Wilkinson & Ors v Feldworth Financial Services Pty Ltd* (1998) 29 ACSR 642 (SCNSW, Rolfe J) at 667 (section 995 liability does not require intent).

A further securities case was *Milner & Ors v Delita Pty Ltd & Ors* (1985) 61 ALR 557 (FCA, Lockhart J) (a claim brought by 50 investors in a guava investment scheme against its promoters and the issuer - no prospectus was required because no “offer to the public” was apparently made). In addition to *Delita* there are a number of time share cases that have been brought under section 52 - see for example *Sanrod Pty Ltd v Dainford Ltd* (1984) ATPR 40-464 and other cases referred to in *Hart (1987)* at 174-5.

<sup>16</sup> “Had the applicant sought to rely on s.995(2) the issues for determination would have been substantially the same.. The scope of the remedies available under ss.1005, 1323, 1324 and 1325 of the Law in the event of the contravention of s.995 may be greater than in the case of s.52 of the *TPA* but that difference is not present in the material.” *Ibid* at 600.

<sup>17</sup> See *Fleming (1992)* at 630 - 1.

disclose information arose, even where the effect of that non-disclosure was injury to another party.<sup>18</sup>

Qualifications to that general principal arose in relation to half truths (where the half truth was regarded as much a false representation as an outright falsehood),<sup>19</sup> where a statement is made which is rendered false by later events,<sup>20</sup> or where a duty of disclosure arises by virtue of a relationship between parties (for example a fiduciary relationship or a relationship of principal and agent).<sup>21</sup>

Against that background the Australian Federal Court has developed a broader concept of “reasonable expectation” over the last few years which has extended the circumstances in which an omission may constitute misleading or deceptive conduct.

The most well known early statement of the doctrine of reasonable expectation is contained in *Demagogue v Ramensky*:<sup>22</sup>

“Silence is to be assessed as a circumstance like any other. To say this is certainly not to impose any general duty of disclosure; the question is simply whether, having regard to all the relevant circumstances, there is conduct that is misleading or deceptive or that is likely to mislead or deceive..... the significance of silence always falls to be considered in the context in which it occurs. That context may or may not include facts giving rise to a reasonable expectation, in the circumstances of the case, that if particular matters exist they will be disclosed”<sup>23</sup>

The position will be clearest in the situation where the general law imposes an obligation of disclosure on the party in question. This is the case with a disclosure document required to be lodged under the *Corporations Act*. Therefore in the *NRMA Case* an obligation of disclosure

<sup>18</sup> *Smith v Hughes* (1871) LR 6 QB 597; *Peek v Gurney* (1873) LR 6 HL 377.

<sup>19</sup> In the prospectus context see for example *Gluckstein v Barnes* [1900] AC 240 discussed in Section 2.4. See also *Peek v Gurney* (1873) LR 6 HL 377 and *Scott, Fell v Lloyd* (1906) 4 CLR 572.

<sup>20</sup> See *Brownlie v Campbell* (1880) 5 AC 925 and *With v O’Flanagan* [1936] Ch 575.

<sup>21</sup> See *Brownlie v Campbell* (1880) 5 AC 925 at 950 (Lord Blackburn). For discussion of a possible more general obligation of disclosure under Australian law see P.D. Finn “*Good Faith and Non-Disclosure*”, Chapter 7 in “*Essays in Tort*” (Finn, ed) 1989, Butterworths.

Contrast the position in the United States where it is a fixture of the federal securities law that silence, absent a duty to disclose, cannot be misleading - see *Backman v Polaroid Corp* 910 F 2d 10 (1st Cir, 1990). See also *Roeder v Alpha Industries Inc* 814 F 2d 22 (1st Cir, 1987). For developments in this area based on the theories set out in this paragraph see D. A. Oesterle “*The Inexorable March Towards a Continuous Disclosure Requirement for Publicly Traded Corporations: ‘Are We There Yet’*” (1998) 20 *Cardozo L Rev* 135.

<sup>22</sup> *Demagogue Pty Ltd v Ramensky & Anor* (1992) 39 FCR 31 (FCA, Black CJ, Gummow & Cooper JJ). The principle has developed through cases such as *Warner & Anor v Elders Rural Finance Limited & Ors* (1993) 41 FCR 399 (FCA, Foster, Hill & Drummond JJ) and *Kimberley NZI Finance Ltd v Torero Pty Ltd* [1989] ATPR 52,193. The leading early cases were *Rhone-Poulenc Agrochimi SA v UIM Chemical Services Pty Ltd* (1986) 12 FCR 477 and *Henjo Investments Pty Ltd v Collins Marrickville Pty Ltd* (1989) 79 ALR 83 (FCA, Lockhart, Burchett & Foster JJ).

<sup>23</sup> *Ibid* at 32 per Black J. See also Gummow J at 41 to similar effect.

had arisen under the general law in providing information to members for the purposes of the general meeting to consider the demutualisation of NRMA. This was considered to provide the context by which an omission could then be tested.<sup>24</sup>

It would seem clear that where a prospectus is involved, section 710 of the *Corporations Act* would similarly provide the disclosure background by which misleading or deceptive conduct would be tested on the reasonable expectation principle.<sup>25</sup>

The reasonable expectation test will give rise to more difficult issues and circumstances where a capital raising is involved but no disclosure document is required to be lodged under the *Corporations Act*. A question arises as to how the *Misleading & Deceptive Conduct Provisions* will apply in these circumstances.

ASIC has suggested<sup>26</sup> that where an issuer of securities is aware of material information not available to the investment community or believes in or suspects the existence of that information, the continuous disclosure requirements of ASX Listing Rule 3.1 imposes a requirement that is capable of giving rise to an expectation by an investor that all public information is current, accurate and complete.<sup>27</sup> In the case of a stockbroker or underwriter involved in a capital raising, such a reasonable expectation is said to arise in the same circumstances by virtue of the requirement that a licenced dealer act efficiently, honestly and fairly.<sup>28</sup> On the other hand it is suggested that where a disclosure document is not required to be

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<sup>24</sup> See *NRMA Case* at 601 (Full Federal Court) and at 671-2 (Gummow J). The Full Federal Court in the *NRMA Case* noted that the distinction between a general law action based on non-disclosure and a section 52 action was that at general law no relief would be granted if the directors had no knowledge of the matter while under section 52 contraventions may occur irrespective of knowledge or fault - *Ibid* at 603.

For discussion in this context see B. Marshall "Section 52 of the Trade Practices Act and the External Legal Order: Lessons from the *NRMA Case*" [1996] 4 TPLJ 126.

<sup>25</sup> See analysis in *NRMA Case* at 600.

The factual complexity of the *NRMA Case* is illustrated by the subsequent litigation by NRMA against its legal advisors in *NRMA Ltd & Ors v Morgan & Ors* (1999) 31 ACSR 435 (SCNSW, Giles J) and on appeal *Heydon v NRMA Ltd & Ors* (2001) 36 ACSR 462 (SCNSW, Malcolm AJA, McPherson AJA and Ormiston AJA) where none of the judges would have followed the findings of misleading or deceptive conduct made by the Federal Court in 1994.

<sup>26</sup> Practice Note 12 "Securities for Sale: Allotment Conduct" issued 30 July 1991 by the Australian Securities Commission.

<sup>27</sup> *Ibid* at paragraph 11.

<sup>28</sup> *Ibid* at paragraph 13. This would seem to be a fairly extreme stretching of the proposition that a reasonable expectation of disclosure should flow, particularly where the information in question is not that of the stockbroker.

The ASIC approach should be contrasted with the position in the United States where it is a fundamental tenet of the securities laws that silence absent a duty to disclose is not actionable under Rule 10b - 5 - See *Basic Inc et al v Levinson et al* 485 US 224 (1987) at 239 (footnote B). In the United States there is no clearly enunciated general continuous disclosure standard that compares to Listing Rule 3.1 (contrast Form 8-K promulgated under the *Securities Exchange Act 1934*).

lodged under the *Corporations Act*, the context is unlikely to require the degree of disclosure as is contemplated by Chapter 6D of the *Corporations Act*.<sup>29</sup>

### A brief comparison with United States law

It is helpful to contrast the Australian position outlined above to the position that exists in the United States in relation to misleading conduct in relation to general securities transactions.

The so-called general “anti-fraud” provision in the United States securities laws is Rule 10b-5 promulgated in 1942 by the SEC under the *Securities Exchange Act 1934*. Rule 10b-5 provides that it is unlawful for any person:

- “(1) To employ any device, scheme, or artifice to defraud,
- (2) To make any 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 under which they were made, not misleading, or
- (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.”

The enabling legislation, section 10(b) of the *Securities Exchange Act 1934*, makes it unlawful to use any “manipulative or deceptive device or contrivance” in contravention of SEC rules.

Like the general history of the Australian *Misleading & Deceptive Conduct Provisions*, the effect of Rule 10b-5 on the United States securities law has been profound.<sup>30</sup> In the words of the United States Supreme Court:<sup>31</sup>

“when we deal with private rights under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn”.

Until the mid-1970s there was a continuing debate in the United States as to the appropriate standard of liability that should underpin Rule 10b-5, the possible alternatives being a scienter<sup>32</sup> standard, a negligence standard or an innocent misconduct standard of culpability. Most courts

<sup>29</sup> Ibid at paragraph 19. Clearly that proposition is correct because an investor would not reasonably expect that the issuer to be offering that level of disclosure.

<sup>30</sup> For a description of the development of Rule 10b-5 see for example *Loss & Seligman (1995)* at 777-780.

<sup>31</sup> *Blue Chip Stamps v Manor Drug Stores* 421 US 723 (1975) at 737.

<sup>32</sup> In the United States “scienter” is analogous to the *Derry v Peek* (1889) 14 AC 337 standard of deceit in Australian law - *i.e.* an intent to deceive, manipulate or defraud (see Section 5.3 below).

and commentators had favoured the imposition of a negligence standard.<sup>33</sup> However, in 1975 the United States Supreme Court resolved the issue in *Ernst & Ernst v Hochfelder*<sup>34</sup> by adopting the higher scienter standard of culpability.

*Ernst & Ernst* involved a Rule 10b-5 claim against accountants based on an allegation of negligence in auditing a brokerage firm. The Supreme Court found that the enabling provisions of Section 10(b) and the use of the terms “manipulative”, “device” and “contrivance” indicates a legislative intent to impose a standard of conduct that is higher than negligence.<sup>35</sup>

The SEC had mounted an argument based on legislative history and the structure of the legislation that a lower standard of culpability than deceit should be required. On this point the Supreme Court decision is instructive. The Supreme Court said that it would undercut the carefully drawn procedural provisions of section 11 of the *Securities Act* (which is negligence based) and related liability provisions to allow the general anti-fraud remedy to cover the same ground.

“Such restriction [to a negligence standard] would allow causes of action covered by ss 11, 12(2) and 15 to be brought instead under ss 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions”.<sup>36</sup>

The striking contrast is of course that the interaction between the prospectus liability provisions and general anti-fraud provisions is exactly the opposite in Australia when compared to the United States.

A point of further interest to the Australian reader is the role of recklessness as a component of the scienter standard of liability. In the *Ernst & Ernst Case* the Supreme Court left open the issue of whether recklessness would meet the scienter standard.<sup>37</sup>

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<sup>33</sup> See for example *Dooley (1972)* at 814-5; *White v Abrams* 495 F 2 724 (1974); *SEC v Texas Gulf Sulphur Co* 401 F 2 833 (1968).

<sup>34</sup> *Ernst & Ernst v Hochfelder et al* 425 US 185 (1975).

<sup>35</sup> *Ibid* at 199. As a consequence Rule 10b-5(2), which does not use the language of fraud that is a feature of both subparagraphs (1) and (3), was considered by the Supreme Court to be read by reference to the enabling legislative requirement and therefore to be construed as requiring a deceit standard of conduct.

<sup>36</sup> *Ibid* at 210. While not referred to by the Supreme Court, it is also instructive that in 1933 Congress had rejected strict liability for prospectus misstatement as an appropriate regulatory approach (due diligence defences were then introduced) - see Section 1.4 at text accompanying footnote 107.

The primary finding of the majority judgment was that as a matter of interpretation of the words of section 10 and the legislative history a stricter standard was required. This is a marked contrast to the *Misleading & Deceptive Conduct Provisions*. Such an approach is not without its critics - see *Loss & Seligman (1995)* at 841-2 (common law deceit does not act to raise standards from the position that existed at common law).

<sup>37</sup> In Footnote 12 (at 194) of the opinion the Supreme Court said:

It has not escaped later courts that a broad interpretation of the concept of recklessness could lower the required standard of conduct to establish liability and therefore potentially undermine the high standard of culpability required by the Supreme Court. For that reason recklessness is generally considered to constitute the required level of culpability only where there is an extreme departure from ordinary care such that the danger of misleading investors is either known or so obvious the person must have been aware of the matter.<sup>38</sup>

The general result of the *Ernst & Ernst Case* is that Rule 10b-5 fell into relative disfavour as the preferred basis of alleged liability for prospectus misstatement.

### Relationship to Prospectus Liability Regime

During the 1990s there has been an ongoing debate about the appropriate interaction of the *Misleading & Deceptive Conduct Provisions* and the prospectus liability regime of the *Corporations Act*. With the enactment of the *CLERP Act* that debate has been resolved by providing that the prospectus liability regime has paramountcy over the *Misleading & Deceptive Conduct Provisions*.

Since the introduction of the *Trade Practices Act* the overlapping liability regimes of Australian law has had the effect of permitting a claim based on section 52 in the same circumstances as potential liability under the prospectus liability regime arising. However, it was only with the enactment of the *Corporations Law* that the consequences of that overlapping regime led to any significant debate. That can be partly explained by the developing jurisprudence of the *Trade Practices Act* case law over the last two decades, with the significant High Court authority as to culpability standards being developed in the early to mid-1980s. It can also be partly explained by the introduction of the then section 995 as a general securities law anti-fraud remedy in the *Corporations Law*, bringing into sharper relief the interaction of the various sections.<sup>39</sup>

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“In certain areas of the law recklessness is considered to be a form of international conduct for purposes of imposing liability for some act. We need not address here a question whether in some circumstances reckless behaviour is sufficient for civil liability under 10(b).”

See *Nelson v Serwold* 576 F 2d 1332 (9th Cir) cert den 439 US 970 (1978); *In Re Victor Technologies Securities Limitation* [1987 Tfr Binder] CCH Fed Sec L Rep 93,158 (ND Cal); *First Interstate Bank of Denver v Pring* 969 F 2 891 (10th Cir 1992); *Hanon v Dataproducts Corp* 976 F 2nd 497 (9th Cir 1992); *Ackerman v Schwartz* 447 F 2 841 (7th Cir 1991).

<sup>38</sup> The leading case is *Franke v Midwestern Oklahoma Development Authority* 428 F Supp 719 (WD Okla, 1976). See also *Sanders v John Nuveen & Co Inc.* 554 F 2d 790 (7th Cir, 1977); *Cook v Avian, Inc* 573 F 2d 685 (1st Cir, 1978); *Phillips Petroleum Securities Litigation* 881 F 2d 1236 (3d Cir, 1989).

<sup>39</sup> Section 995 was initially adjacent to the prospectus offence of *CL* section 996, with each *CL* section reliant on section 1005 to establish the remedy in damages.

The fundamental issue is that the prospectus liability provisions adopt a culpability level analogous to the tort of negligence while the *Misleading & Deceptive Conduct Provisions* adopt a level of culpability that is unrelated to fault. The effect, from a practical perspective, was to render superfluous the prospectus liability provisions, particularly in circumstances where the damages remedy for both regimes were expressed in identical terms.<sup>40</sup>

An alternative argument that the scope of the *Misleading & Deceptive Conduct Provisions* should be narrowed in the context of prospectus misstatement liability could be developed by reference to the so-called “side-wind” argument.<sup>41</sup> This argument is to the effect that the Commonwealth legislature in enacting the *Trade Practices Act* could not have intended to intrude into the field of securities regulation and destroy by way of side-wind a fundamental concept of securities law.

An example of the side-wind argument is *Webb Distributors (Aust) Pty Ltd v State of Victoria*<sup>42</sup> where the High Court held that a liquidator could not use section 52 of the *Trade Practices Act* to defeat the long-established securities law principle of the rule in *Oakes v Turquand* and *Houldsworth v City of Glasgow Bank*.<sup>43</sup> The High Court concluded that:

“The Trade Practices Act is unquestionably a piece of innovative legislation. But it is not to be seen as eliminating, ‘by a side-wind’, the detailed provisions established for more than 100 years to govern the winding up of a company.”<sup>44</sup>

As such, the operation of section 52 was interpreted consistently with the common law legal principle. This decision follows on from earlier High Court authority in *Parkdale Custombuilt Furniture v Puxu*<sup>45</sup> and in *Concrete Constructions v Nelson*.<sup>46</sup>

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<sup>40</sup> As examples of prospectus offering cases that have bypassed the traditional misstatement regime in favour of the *Misleading & Deceptive Conduct Provisions* see *Famel Pty Limited v Burswood Management Limited* (1989) ATPR 40-692 and *Morey v Transurban City Link Ltd* (1996) 20 ACSR 388.

<sup>41</sup> For analysis of the side-wind argument see M. Gillooly “*Misleading or Deceptive Conduct under Section 995 of the Corporations Law*” at 74-9 in C. Lockhart (ed) “*Misleading or Deceptive Conduct: Issues and Trends 1996*”, The Federation Press. See also the description in *Croker* (1998) at 41-4.

<sup>42</sup> *Webb Distributors (Aust) Pty Ltd v State of Victoria* (1993) 179 CLR 15; 11 ACSR 731.

<sup>43</sup> (1867) LR 2 HL 325 and (1880) 5 AC 317, respectively, being authority for the general proposition that a shareholder who has suffered a misrepresentation cannot claim damages from a company after the winding up of the company had commenced.

<sup>44</sup> 11 ACSR at 743.

<sup>45</sup> *Parkdale Custombuilt Furniture Ltd v Puxu Pty Ltd* (1982) 149 CLR 191 where Brennan J stated that section 52 by a side-wind should not be seen to alter the balance of the Patents Act and Designs Act in relation to industrial property rights (at 224).

<sup>46</sup> *Concrete Constructions v Nelson* (1990) 169 CLR 594 where a narrow interpretation of the trade or commerce requirement of section 52 was adopted as consistent with avoiding side-winds (at 603-4).

The difficulty with this proposition in relation to the interaction of the *Misleading & Deceptive Conduct Provisions* as they applied to the structure of the prospectus liability provisions of the *Corporations Law* was that the *Corporations Law* specifically contemplated the separate availability of other remedies. In addition, the availability of a due diligence defence is a legislative device that has run through the companies legislation over the last 100 years as an adjunct to other remedies, rather than a discrete principle developed by the common law. As such, there must be suspicion that the side-wind argument would not be supported by an Australian court as a basis for limiting the operation of the *Misleading & Deceptive Conduct Provisions* in the securities law area.<sup>47</sup>

The original terms of the *Corporations Law* also gave rise to ambiguities of interpretation. For example, it was not clear if an action was brought under the then section 995 in relation to a prospectus misstatement whether the prospectus due diligence defences could be applied to that conduct. This was because the legislation provided that if an action for damages was brought in connection with the issue of a prospectus the various persons involved in the prospectus preparation process would face deemed primary civil liability but would have available to them the various prospectus liability defences. The regime was not expressed to be predicated on any particular contravention of the legislation.<sup>48</sup> The alternative argument was that the then section 995 should operate as a code and, like *TPA* section 52, should not be considered to have any defences to liability. The better view would seem to have been that the liability defences would be available in the then section 995 action for prospectus misstatement to the extent of overlapping liability.<sup>49</sup>

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<sup>47</sup> *Gillooly* Supra at 78 and *Croker (1998)* at 43 argue the decision in *Fraser v NRMA (1995)* 15 ACSR 590 at 599 gives some support to the side-wind argument because reference is made to the decision of Brennan J in *Parkdale v Puxu*. It is argued that because the case only involved an application for an injunction and not damages it was not necessary to apply the side-wind principles to qualify section 52 by the defences in *CL* 1007-1011. However, it is difficult to draw that conclusion from the reasoning adopted by the Full Federal Court.

A tentative reference to the side-wind argument is noted by McPherson AJA in *Heydon v NRMA Ltd & Ors (2001)* 36 ACSR 462 (SCNSW, CA) at 600 where that terminology is used to justify the non-application of accessory liability provisions to ground a claim by a company against its legal advisors for a misstatement alleged in a disclosure document. However, that situation was more specific than the general argument summarised above.

<sup>48</sup> See section 1006(1) that imposed the primary liability on persons listed in section 1006(2) and the preamble to each defence in sections 1007-1011 that provided a person specified in section 1006(2) would not have liability in an action under section 1005.

<sup>49</sup> The views of this author in support of that argument are set out in *Golding (1993)* at 423-4 and *Golding (1997)* at 323. For other advocates see *Croker (1998)* at 37-40. That approach was also recognised by the Lonergan Committee who recommended that the provisions of the *CL* that relate specifically to prospectuses should prevail over s. 52 - *Lonergan Committee Report* at 90.

For advocates of the alternative view see E. Vareges "Prospectus Provisions of the Corporations Law" (1991) *Law Society Jnl* 59 at 64; R. Baxt, H.A.J. Ford & A. Black "Securities Industry Law" 5th Edition, 1996 at 81-2.

ASIC also publicly supported the alternative view. See "First Part of ASC Comments Regarding Recommendations of Lonergan Committee" (May 1992) (ASC) at paragraph 8.3.

However, irrespective of the outcome of that debate the plaintiff could instead have proceeded under section 12DA of the *ASIC Act* or the *Fair Trading Acts*. It is clear with that legislation (as with *TPA* section 52) that liability was overlapping and not subject to any defences.

Having regard to the above analysis, compelling arguments could be made for statutory change to ensure that the prospectus liability regime remained relevant.<sup>50</sup> The debate involves resolution of the threshold issue of what is the appropriate standard of culpability that should apply to prospectus misstatement; the negligence standard of the historic prospectus liability regime or the no-fault standard of the section 52 jurisprudence.

In 1995, following the debate generated by the *NRMA Case*, the Attorney General referred these issues to the *Simplification Task Force* for consideration. The *Simplification Task Force Report on Fundraising* observed that the liability balance set out in the fundraising provisions is undermined by the *Misleading & Deceptive Conduct Provisions*, that this caused uncertainty and greater costs for business and that such a liability standard is inconsistent with international practice.<sup>51</sup>

The analysis of this dissertation clearly supports the views expressed in that report.<sup>52</sup> In moving from the *Derry v Peek* fraud standard of culpability to a negligence standard of culpability, deterrence is supported. An investment in securities involves an assumption of risk and, provided those who prepare disclosure documents exercise care, they are not required to act as guarantors of the accuracy of the information provided.

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<sup>50</sup> This author's views are set out in *Golding (1997)* at 320-322.

<sup>51</sup> *Simplification Task Force Report on Fundraising* at pages 19-20.

"Given the obligations which the Law imposes on those involved with fundraising and takeovers to disclose all relevant information, defences play an important role. They ensure an appropriate balance is struck between the rights of investors and the obligations of business. This carefully chosen balance is undermined if investors can succeed in an action under the *TPA* where defences are not available, in circumstances where there are defences under the law.

The different operation of 2 regimes provides an uncertain environment for business. Despite taking every possible precaution to comply with the requirements of the *Corporations Law*, business is likely to remain exposed to liability because it is not able to rely on the *Corporations Law* defences. The result is to increase the cost of fundraising by Australian business.

Furthermore, this approach is inconsistent with international practice for the regulation of fundraising and takeovers. The approach of imposing stringent liability coupled with due diligence style defences is in line with the approach taken to regulating fundraising in comparable jurisdictions."

The *Wallis Committee Report* made the same recommendations as the *Simplification Task Force* - see at 45-48.

<sup>52</sup> For a vigorous defence of the alternative view that the section 52 jurisprudence should have primacy see *Pitchford (1998)*. Pitchford argues from an economic perspective that due diligence is inferior to strict liability because of the increased cost and complexity created by the regime.

The *Simplification Task Force* therefore recommended that the operation of the *Misleading & Deceptive Conduct Provisions* be excluded from the fundraising area.<sup>53</sup> In addition, in 1996 the *Simplification Task Force* released further recommendations that the *Corporations Law* and the *Trade Practices Act* be amended so that the *Corporations Law* deal exclusively with the regulation of dealings in securities.<sup>54</sup>

While the views of the *Simplification Task Force* met resistance from some quarters, particularly the Australian Consumer & Competition Commission,<sup>55</sup> the business community strongly supported the proposal.

The *CLERP Bill* therefore inserted CA the then section 995(2A) 1041H (section 1041H(3) from 11 March 2002) which provides that conduct that contravenes section 728 does not contravene section , and for these purposes conduct contravenes the provision even if the conduct does not constitute an offence or lead to liability because of a defence.<sup>56</sup>

The Minister for Financial Services and Regulation made the following comments in the second reading speech on introducing the *CLERP Bill*:

“It is also clear that uncertainty over liability for the content of prospectuses has added to the complexity and expense of fundraising and has detracted from the prime function of a prospectus to disclose relevant information to investors. The government will clarify the potential liability of parties for prospectuses by providing that their liability is governed solely under the Corporations Law. Due diligence defences will be made available in all cases of fundraising where there is a positive duty to disclose information”.<sup>57</sup>

The above quotes suggest that there had been a cost associated with the *TPA* section 52 liability regime. It is difficult to see that cost having regard to the absence of any litigation based on section 52/section 12DA undermining the assertion of a defence created by the *Corporations*

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<sup>53</sup> *Simplification Task Force Report on Fundraising* at page 21.

<sup>54</sup> Report by Corporations Law Simplification Task Force “*Section 52 Trade Practices Act and Dealings in Securities*” (September 1996, AGPS).

<sup>55</sup> See ACCC “*Submission to the Corporations Law Simplification Task Force*” (1996) and ACCC Journal No.2 “*Corporations Law Simplification Task Force*” (1995/6) arguing among other things it would undermine the operation of the Trade Practices Act to create a precedent of this nature and that a no-fault culpability standard now had a substantial historical support. The last comment, in particular, was somewhat selective having regard to the historical standard of culpability that has operated in the securities area. For discussion see *Hone (1996)* at 318.

<sup>56</sup> Also excluding liability under section 670A (takeover documents) in the same way. From 11 March 2002, this section is replaced by section 1041K of the *Corporations Act* and section 12DA(1A) of the *ASIC Act*.

Liability under the *Fair Trading Acts* of each state is removed by section 1041K(2) of the *Corporations Act* (from 11 March 2003) which provides the provisions of that legislation do not apply to dealings in securities.

<sup>57</sup> *Hansard - House of Representatives*, 3 December 1998 at 1285.

*Law*. However, if there had been the incidence of such litigation such a cost is well likely to have arisen.

The ambiguities of the operation of the *Corporations Law* provisions discussed above clearly do not apply following the enactment of the *CLERP Act*.<sup>58</sup> However, the new provisions are not without their difficulties.

It has been suggested that the language that seeks to provide for exclusion of liability is inadequate as currently drafted. This is because the conduct excluded from section 1041H is conduct contravening section 728, being the offering of securities under a disclosure document. It is argued that conduct ancillary to the offering of the securities, such as distributing the disclosure document would not be excluded and, as a result, section 1041H would continue to apply to that conduct even though it relates to the disclosure document.<sup>59</sup> However, that interpretation would seem to be an unduly narrow statutory interpretation of the language of the exclusion and inconsistent with the extrinsic material available in relation to the intended operation of the section.

A further difficulty identified is that an action based on section 1041H will be potentially different to an action commenced under Section 12DA of the *ASIC Act* and *TPA* section 52 because the various consumer protection and interpretative provisions found in Part 2, Division 2, Subdivision B of the *ASIC Act* and Part V of the *TPA* are not incorporated into the *Corporations Act* to aid the operation of section 1041H.<sup>60</sup> It is therefore argued that the amendments implemented open up a “regulatory gap” in relation to dealings in securities generally.

However, this concern seems exaggerated because the legislative provisions, which found the basis of the jurisprudence relating to the *Misleading & Deceptive Conduct Provisions* relevant to the issues discussed in this dissertation, are all found in the *Corporations Act*. As such, it is unlikely that significant difficulties in the operation of the scheme of regulation will arise in practice.

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<sup>58</sup> There is now no overlap with section 1041H and the “side-wind” arguments are irrelevant. See Explanatory Memorandum to *CLERP Bill* at paragraphs 8.25-8.28.

<sup>59</sup> See *Ford, Austin & Ramsay (2000)* at paragraph 4.36.

<sup>60</sup> See *Croker (1998)* at 74-5.

The more fundamental difficulty from the policy perspective with the *Corporations Act* regime following the enactment of the *CLERP Act* is that the no-fault culpability regime of *CA* section 1041H and section 12DA of the *ASIC Act* continue to regulate disclosures made in the securities law context outside of disclosure documents required to be lodged under the fundraising provisions and takeovers provisions of the *Corporations Act*.

Traditionally, the preparation of formal disclosure documents such as prospectuses have involved an area where special care was considered by the legislature to be required, with the result that a heightened standard of culpability applied to the persons involved in that process to ensure special care was undertaken. Now in Australia, the reverse position applies in that a negligence standard (the traditional standard) applies to a misstatement in a prospectus but a no-fault standard applies to misstatement in other more routine disclosures that may be made in relation to securities.

Therefore if, for example, a statement is made to the market and is then repeated in a prospectus, no defences will be available from civil liability for the statement made to the market but due diligence defences will be available for the statement included in the prospectus.<sup>61</sup>

As noted above, the United States position is the reverse with its deceit standard for general anti-fraud liability.<sup>62</sup> For the Australian regime, such an approach would be much sounder from the policy perspective. This issue was not recognised in the explanatory materials to the *CLERP Bill*. It creates an ongoing fundamental policy failing in the operation of the Australian securities laws.

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<sup>61</sup> If the statement was required to be made under the continuous disclosure regime, Chapter 6CA (from 11 March 2002) imposes potential civil liability. Again, section 1041H is undermining liability rules set out in the *Corporations Act*. Again, the possible “side-wind” argument rears its head.

The continuous disclosure regime is replaced by Part 6CA of the *Corporations Act* from 11 March 2002.

As noted below, this consequence will continue to render the civil liability aspects of general provisions such as sections 999 and 1000 of the *Corporations Act* superfluous.

<sup>62</sup> By way of further comparative analysis of the proposition that the general liability regime should not be less extensive to prospectus liability in imposing culpability requirements see:

- Hong Kong - Section 8 of the *Protection of Investor Ordinance* that imposes general civil liability for fraudulent, reckless or negligent misstatements.
- England - The *Misrepresentation Act 1967* that allows a person who enters a contract as a result of a misrepresentation to recover if the tort of deceit would have allowed recovery if made fraudulently. A due diligence defence is available for reasonable grounds of belief in the truth of the statement. The remedy is only available as between parties to a contract. Beyond this statutory remedy the position remains dealt with by the torts of negligence and deceit.

## 5.2 OTHER CORPORATIONS ACT REMEDIES

In addition to the *Misleading & Deceptive Conduct Provisions*, the *Corporations Act* itself provides a variety of additional remedies that are potentially relevant to prospectus misstatement. It is useful to briefly identify those provisions and determine their relevance to the prospectus liability debate.<sup>63</sup>

### Section 1041E

Section 1041E is entitled “false or misleading statements in relation to securities” and has developed from the market manipulation provisions of the *Corporations Act*. Section 1041E is both a criminal offence and gives rise to a civil liability consequence (through section 1041I of the *Corporations Act*).<sup>64</sup>

The genesis of section 1041E was from the stock market collapse of the late 1960s and concerns that then existed as to perceived misstatements made in the context of secondary trading in securities on the stock markets (as well as the other abuses ultimately catalogued by the Rae committee). The result was new legislation introduced in both New South Wales<sup>65</sup> and Queensland.<sup>66</sup>

These provisions found their way into the 1981 *Securities Industry Code* (adjunct legislation to the 1981 *Companies Code*) of each state as section 125.<sup>67</sup>

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<sup>63</sup> Following the enactment of the *Financial Services Reform Act 2000* from 11 March 2002, sections 999 and 1000 are to be restated. The restated provisions are not materially different to the predecessor provisions except as noted below. Section 999 becomes section 1041E of the *Corporations Act*. Section 1000 becomes section 1041F of the *Corporations Act*.

<sup>64</sup> From 11 March 2002, previously the remedy was in section 1005. This section was originally an offence only with no civil remedy - see discussion in *Hart (1987)* at 168. It was only with the enactment of the *Corporations Law* that a civil consequence was introduced.

<sup>65</sup> Section 73 of the *Securities Industry Act 1970* (New South Wales) contains the most direct genesis prohibiting a person “with respect to securities” making statements in disseminating information “he knows or has reasonable grounds for knowing” is materially false or misleading.

<sup>66</sup> Section 94 of the *Securities Industry 1971* (Queensland) adopted the same approach.

<sup>67</sup> Section 125 was more narrowly defined than the New South Wales and Queensland predecessor legislation in that the relevant misstatement was required to have or likely to have the effect or inducing the sale or purchase of securities by other persons or raising, lowering, maintaining or stabilising the market price of securities. The original New South Wales and Queensland provisions merely required that the matter be with respect to securities.

In *R v M & Ors (1979)* 4 ACLR 610 (ASLC 85,367) the NSW Court of Criminal Appeal said “in respect of” meant the prohibition only applied to statement which have as their subject matter securities (a half yearly statement and notice of meeting was considered to relate to securities of that company).

The determinant of liability under section 1041E and its predecessors has always been linked to a culpability standard based on tort concepts. As currently formulated it is necessary to prove that the person either:

- does not care whether the statement or information was true or false; or
- knows or ought reasonably to have known that the statement or information is materially false or misleading.

The current formulation of section 1041E has the following elements, in addition to the culpability standard:

- the person must make a statement or disseminate information that is materially false or misleading; and
- the statement or information must be likely to induce other persons to subscribe for securities or sell or purchase securities or must be likely to have the effect of increasing, reducing, maintaining or stabilising the market price of securities.

There have been few cases involving section 1041E.<sup>68</sup> The case law that exists is more related to a technical analysis of the elements of each offence instead of inquiry into the standard of conduct required to establish liability. As such, the case law is of little assistance here.<sup>69</sup>

The requirements of knowledge of falsity and lack of care come from the tort of deceit. The requirement that a person ought reasonably to have known that a statement or information is false approaches a negligence standard.<sup>70</sup> The critical distinction between the prospectus liability regime and section 1041E liability is that no obligation of enquiry is specifically imposed by the legislation on the relevant person in determining reasonableness of knowledge for purposes of potential liability.

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<sup>68</sup> The cases are *R v M & Ors* (1979) 4 ACLR 610 (ASLC 85,367) (a prosecution under section 73 of the *Securities Industry Act 1970* (NSW)), and *R v Wright* (1980) 4 ACLR 931, [1980] VR 593 (a prosecution under section 110 of the *Securities Industry Act 1975* (Vic)).

It will be noted that the prosecution in the White Constructions Limited prospectus of the early 1990s was based on the predecessor legislation to section 999 - see footnote 34 to Chapter 1.

<sup>69</sup> Both cases involved actions against directors of companies in relation to statements released to the market.

<sup>70</sup> To similar effect see *Hart* (1989) at 169.

The fundamental difficulty with section 1041E in the context of misstatement liability is that it has largely been rendered superfluous for civil actions by the *Misleading & Deceptive Conduct Provisions* jurisprudence. The higher standard of culpability under section 1041E means that no civil plaintiff would be likely to rely on the section. In addition, the requirement that the statement be “likely to induce” is more restrictive than the relevant nexus under section 1041H.

Section 1041E still retains a role for criminal prosecutions. As discussed in Chapter 2, the regime established by Part 6D.3 is analogous to a negligence standard, which (subject to the above comments) is also the level of culpability established by section 1041E.

A confusing development in relation to section 1041E was its amendment in 1994 to include, not only secondary market dealings, but also the subscription for securities.<sup>71</sup> The impetus for the reform was said to be a recommendation of ASIC.<sup>72</sup> However in view of the presence of Part 6D.3 in covering the same ground it is difficult to see what practical objective that amendment achieves.

### Section 1041F

Section 1041F of the *Corporations Act* (entitled “inducing persons to deal”) imposes potential criminal and civil liability (again through section 1041I) on a person who induces or attempts to induce other persons to deal in securities in one of the following ways:

- by making or publishing a statement, promise or forecast that the person knows or is reckless as to whether the statement is misleading, false, or deceptive ((1)(a));
- by dishonest concealment of material facts ((1)(b));
- by recording or storing in by means of a device, information that the person knows to be materially false or misleading ((1)(c)).

The genesis of section 1041F of the *Corporations Law* is section 13 of the *Prevention of Fraud (Investments) Act* 1958 (England), which itself was based on section 84 of the *Larceny Act* 1861

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<sup>71</sup> Addition of section 999(aa) by Item 14 of Schedule 12 of *Corporate Law Reform Act* 1994 (No 31 of 1994).

<sup>72</sup> See paragraph 312 of Explanatory Memorandum to *Corporate Law Reform Bill* 1993. This presumably followed from the failed prosecution in the White Industries case.

(England).<sup>73</sup> There is a small body of case law that is helpful in assessing the operation of section 1041F.<sup>74</sup>

The case law displays an ongoing debate as to whether section 1041F merely restates the standard of culpability for liability in the tort of deceit or whether a lower level of culpability applies. Clearly the knowledge requirement of paragraph 1(a) and the dishonest concealment requirement of paragraph 1(b) equate to the tort of deceit.<sup>75</sup> The debate has been whether the alternative requirement of recklessness in paragraph 1(a) involves something more than deceit.

In *R v Bates & Russell*, recklessness was equated with carelessness.<sup>76</sup> On the other hand, in *R v Mackinnon & Anor* it was said that having regard to the context of the provision and, among other things, inclusion of the word fraud in the heading to the section, recklessness requires the application of the same meaning as that attributed to the term in *Derry v Peek*, with the result that some dishonesty is required.<sup>77</sup>

To confuse things further, in the subsequent case of *R v Grunwald* recklessness was instead equated with “heedless rashness” and it was considered unnecessary to define dishonesty for these purposes.<sup>78</sup> As such, three alternative standards of culpability were reflected in the case law. To perpetuate this uncertainty, in the Australian case of *Pollard v DPP*<sup>79</sup> the approach of *R v Mackinnon* was preferred over the other alternative formulations as to the relevant level of culpability.

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<sup>73</sup> The 1958 act replaced section 12 of the *Prevention of Fraud (Investments) Act 1939*. It was itself replaced by section 21 of the *Protection of Depositors Act 1963*.

Again, this section was originally an offence only with no civil remedy and it was only with the enactment of the *Corporations Law* that a civil consequence was introduced.

<sup>74</sup> See *R v Kysant (Lord)* [1932] 1 KB 442; *R v Bates & Russell* [1952] 2 All ER 842; *R v Russell* [1953] 1 WLR 77; *R v McKinnon & Ors* [1959] 1 QB 150; *R v Grunwald & Ors* [1953] 1 QB 150. In Canada see *R v Colucci* (1965) Ont R 665.

<sup>75</sup> See *R v Mackinnon & Ors* Ibid at 154:-

“There is very little, if any difference between categories one and two [corresponding to (1)(a) and (1)(b)]. It would appear that category two is included only ex abundanti cautela to cover the sort of facts that existed in *Rex v Kysant*.”

<sup>76</sup> Ibid at 846 (per Donovan J).

<sup>77</sup> Ibid at 155 (per Salmon J). Prior to 11 March 2002 the section referred to reckless conduct characterised as “dishonest or otherwise”.

<sup>78</sup> Ibid at 939 (per Paull J).

<sup>79</sup> *Pollard v Commonwealth Director of Public Prosecutions & Anor* (1992) 8 ACSR 813. The case involved section 178BB of the *Crimes Act* (NSW) - discussed below. It is significant that the *Crimes Act* statutory provision does not include the parenthetical wording “dishonestly or otherwise”.

Following that time the legislation was amended in England to make it clear that a reckless statement made honestly will contravene the section.<sup>80</sup> The paragraph (1)(c) limb was added in 1985<sup>81</sup> but that limb only addresses the traditional deceit standard of conduct rather than the culpability issue raised by the third limb.

The *Financial Services Reform Act 2001* has sought to clarify the issue in Australia by introducing a definition of “dishonest” for the purposes of the section. For these purposes dishonest means dishonest according to the standards of ordinary people and known by the person to be dishonest according to the standards of ordinary people. Further, a new section 1041G was introduced to create an offence if a person in the course of a carrying on a financial services business engages in dishonest conduct in relation to a financial product or financial service. The same definition of dishonest applies.

The background materials to the *Financial Services Reform Act 2001* do not explain the reasons for these changes.<sup>82</sup> In addition the definition of dishonesty does not clearly resolve the three alternative standards of culpability reflected in the above case law in a way that specifically addresses the issues identified in those cases. The definition would seem to define dishonesty by reference to an objective standard that would constitute knowledge on the part of a reasonable person.

Again, the same concluding comments on the relevance of section 1041F can be made in the prospectus misstatement context as were made above in relation to section 1041E. The availability of section 1041H renders section 1041F superfluous for civil actions. The section remains relevant to criminal prosecutions.

The more pressing issue is to assess why the separate provisions of sections 1041E, 1041F and 1041G are required. The provisions have come from separate backgrounds but are now adjacent to each other in the *Corporations Act*. They largely cover the same ground. The levels of culpability are similar (subject to the deceit versus negligence debate discussed above). A good case could be made for simplifying the provisions into a single section, with an emphasis on

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<sup>80</sup> Section 21 of the *Protection of Depositors Act 1963*. This followed recommendations made in 1962 by the Jenkins committee (“*Report of the Company Law Committee*” (1962, Cmnd 1749)), at paragraphs 253-255. The Jenkins committee had argued for a negligence standard of culpability for civil liability but a fraud standard for criminal liability.

<sup>81</sup> The *Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985* (No 192 of 1985) intended to make it clear the prohibition will apply to information stored in a computer (paragraph 718 of Explanatory Memorandum to bill).

<sup>82</sup> See paragraph 15.18 of the Explanatory Memorandum to the *Financial Services Reform Bill 2001*.

criminal liability rather than civil liability. That opportunity was not taken with the *Financial Services Reform Act 2000*.

### Miscellaneous Disclosure Offences

Part 9.4 of the *Corporations Act* provides for certain miscellaneous disclosure offences. Section 1308(2) provides that it is an offence for a person who, in a document required by the *Corporations Act* to be lodged with or submitted to ASIC, to make or authorise the making of a statement that to the persons knowledge is false or misleading in a material particular or an omission of any manner or thing which to the persons knowledge is misleading in a material respect.<sup>83</sup> In addition, the same applies if the person has not taken reasonable steps to ensure the statement was false and misleading and contained a relevant omission.<sup>84</sup>

This provision is supplemented by section 1309(1) of the *Corporations Act* which provides that it is an offence for an officer<sup>85</sup> of a Corporation who makes available or furnishes information or authorises or permits the making available or furnishing of information to, among other things, a director or member or a securities exchange where the information relates to the affairs of the corporation and is to the knowledge of the officer false or misleading in a material particular or has omitted from it a matter which renders the information misleading in a material respect. The offence is similarly expanded by reference to information where reasonable steps have not been taken to ensure the information was not false or misleading or contains a relevant omission.<sup>86</sup>

These offences have not been excluded from the liability regime in Part 6D.3 in the same way as section 1041H. As such they can have overlapping effect with Part 6D.3. As a general matter it would seem that the primary offences based on knowledge are analogous to the level of culpability contained in the traditional criminal law offences described in section 5.4 below. The level of culpability of failing to take reasonable steps would appear to be less than a recklessness standard and broadly equivalent to the effect of the Part 6D.3 regime as discussed in section 4.3.

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<sup>83</sup> Further, section 1308(3) extends the application of the provision to statements based on information known to be false or misleading or containing an omission.

<sup>84</sup> Section 1308(4). Section 1308(5) again extends the provision to statements based on information where reasonable steps have not been taken to ensure there is no false or misleading statement or omission.

<sup>85</sup> The definition of officer in the *Corporations Act* extends to directors and persons who make or participate in making decisions that affect the whole or a substantial part of the business of the corporation, who have the capacity to affect significantly the corporation's financial standing or in accordance with whose instructions or wishes the directors of the corporation are accustomed to act (section 9).

<sup>86</sup> Section 1309(2).

For the same reasons as outlined in Section 5.1 it can be argued that the overlap is undesirable to the extent it undermines the operation of Part 6D.3.

### The Stop Order Power

It was noted in chapter 1 that the stop order power is a key tool in ASIC's regulatory armoury and has increasingly been used in recent years.<sup>87</sup> ASIC perceives that the use of stop orders is its principal means of dealing with inadequate disclosure. As such, the stop order power is pivotal to the scheme of regulation in Chapter 6D. The stop order power was introduced with the enactment of the *Corporations Law*. The provision is closely based on United States law.<sup>88</sup>

Under section 739 of the *Corporations Act* if ASIC is satisfied that a disclosure document contravenes the prohibition on misstatement it can order that no offers be made.<sup>89</sup> Procedural fairness must be afforded in that process.<sup>90</sup> There is an interlocutory power to make interim stop orders.<sup>91</sup>

The use of a stop order power is clearly a potent weapon in the hands of ASIC. Having regard to the speed at which capital raising takes place and the need for positive publicity in undertaking a securities offering, the risk of delay and adverse publicity is taken very seriously by issuers.

Clearly in the years surrounding the 2000 tech wreck the use of the stop order power has become a potent weapon in the hands of ASIC.<sup>92</sup> However, an analysis of the use of the power would seem to suggest that it is predominantly exercised in connection with small offerings where the issuer frequently does not have the resources to engage with ASIC on the disclosure issues that

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<sup>87</sup> See footnotes 38 - 40 of Chapter 1.

<sup>88</sup> Section 8(d) of the *Securities Act* 1933.

The Explanatory Memorandum to the *Corporations Bill* 1988 said the provision was based on the *Securities Act* 1978 of Ontario (which itself is based on the United States provision) - at paragraph 3088.

<sup>89</sup> The stop order power was subject to simplification under the *CLERP Act*.

The previous *Corporations Law* section 1033 gave ASIC the stop order power based on a "substantial" contravention of any requirement of the legislation, a statement promise estimate or forecast being false or a prospectus containing a "material" misstatement (section 1022(2)).

It can be argued that section 739 narrows the breadth of the power, limiting the trigger to misstatement issues only. However that is consistent with the United States model.

<sup>90</sup> A hearing and opportunity to be heard must be afforded - section 739(2).

<sup>91</sup> Lasting for up to 21 days pending a hearing or resolution of the matter - section 739(4) and (4).

<sup>92</sup> See section 1.2.

are raised.<sup>93</sup> As such, it can be argued that ASIC will be able to use its stop order power in circumstances where the issuer is ill-equipped to deal with the issues raised, with the result that issues of contestability of ASIC's position may arise. Further, it would seem that ASIC has used its exercise of this power for media purposes<sup>94</sup> to argue it is addressing substantive misstatement issues without vigorously using the traditional prospectus misstatement remedies the subject of this dissertation.

The limitation of the stop order remedy is, of course, its relevance is lost once the offering is complete. It can be expected that in many, if not most instances, prior detection of a problem will not be possible for a regulator. As such, the stop order power can only be seen as one aspect of the regulatory armoury to achieve an appropriate level of deterrence.

### Other Remedies

Part 9.5 of the *Corporations Act* provides for miscellaneous remedies if a breach of a section of the *Corporations Act* is established (including the miscellaneous offences noted above).

Section 1325 of the *Corporations Act* is based upon section 87(1) of the *Trade Practices Act*.<sup>95</sup> The orders that can be made are general and may include orders altering or cancelling contracts and orders for the payment of damages.<sup>96</sup>

Orders can only be made under these provisions in proceedings have been instituted under some other provision of the *Corporations Act*<sup>97</sup> and may only be made in favour of a party to those proceedings.<sup>98</sup> The making of orders under this section is discretionary<sup>99</sup> and orders may be made irrespective of whether or not loss or damage has then been suffered, provided there is a real chance or possibility of loss or damage.<sup>100</sup>

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<sup>93</sup> A review of ASIC announcements relating to the use of the stop order power (see ASIC press releases 01/112 and 01/052 as further described at footnote 40 to Chapter 1) discloses that the vast majority of the circumstances where stop orders were issued related to very small capital raisings.

<sup>94</sup> See the title of the press releases 0/052 "*Consumers Protected by Interim Stop Orders*" (22 February 2001) and 01/112 "*Further Intervention by ASIC on Fundraising Disclosure*".

<sup>95</sup> Paragraph 3956 of Explanatory Memorandum to *Corporations Bill* 1988.

<sup>96</sup> For a description in the *Corporations Act* context see M Gillooly "*Misleading or Deceptive Conduct under section 995 of the Corporations Law*" at 82-4 in C Lockhart (ed) "*Misleading or Deceptive Conduct: Issues and Trends*" 1996, The Federation Press.

<sup>97</sup> *Sent v Jet Corp of Australia* (1986) 160 CLR 541 at 543.

<sup>98</sup> *Ibid.*

<sup>99</sup> *Australian Securities Commission v Sackley* (1991) 4 ACSR 739 at 747 (FCA, Pincus J).

<sup>100</sup> *Western Australia v Wardley* (1991) 102 ALR 213 at 228, *Poignand v NZI Securities* (1992) 109 ALR 213; *Demagogue v Ramensky* (1993) ATPR 41-203.

Section 1325(2) of the *Corporations Act* provides a similar remedy to a person who has suffered or is likely to suffer loss or damage because of conduct of another person engaged in contravention of Chapter 6D of the *Corporations Act*. An issue has been raised as to whether this remedy is also restricted to circumstances where proceedings are instituted under some other provision of the *Corporations Act*.<sup>101</sup> It has been argued that the better view is that remedies are available under this provision independently of the commencement of proceedings under another provision,<sup>102</sup> although greater clarity would be desirable.

Outside these specific statutory provisions, remedies based on implied rights arising from the statutory prohibitions are potentially available. For example, it has been argued that a remedy of rescission should arise from a breach of the statutory prohibition on prospectus misstatement.<sup>103</sup> However there is no case law that supports such a view.

### 5.3 COMMON LAW AND EQUITABLE REMEDIES

#### Rescission

Prior to legislative intervention in the late nineteenth century, the traditional common law remedy for prospectus misstatement was rescission, a remedy based in contract law. If a subscription for shares is obtained by a material misrepresentation of fact the contract is voidable at the election of the subscriber.<sup>104</sup> Where the remedy of rescission is available, the court will order rescission of the contract to subscribe for the shares and order restitution of the money paid under the contract (with interest).<sup>105</sup> The remedy remains available at common law.

The remedy of rescission does not require a showing of culpability on the part of the persons making the representation. Provided it is established that the misleading statement is material, proof of fraud or intent to deceive is not required.<sup>106</sup> The remedy of rescission involves

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<sup>101</sup> See E Varejes “*Prospectus Provisions of the Corporations Law: Liability and Defences*” (1991) 60 LSJ 59 at 64 relying on the absence of section 87(1C) of the *Trade Practices Act* introduced into that legislation in 1986 to overcome the effect of the *Sent Case*.

<sup>102</sup> See *M Gillooly* supra at 83-4 referring to section 1325(4) and the use of the term “cause of action”.

<sup>103</sup> See *Heerey* (1967) at 445-7 citing Wallace & Young “*Australian Company Law & Practice*” (1965) at 139. For contrary authority see *Commonwealth Homes & Investment Co Ltd v Smith* (1937) 59 CLR 443 at 460 (Dixon J).

<sup>104</sup> The leading case is probably *Western Bank of Scotland v Addie* (1867) LR 1 Sc & Div 145 (House of Lords). In Australia see *Re Australian Slate Quarries Limited* (1930) 31 SR (NSW) 1.

<sup>105</sup> See *Central Railway Company of Venezuela (Directors, etc) v Kisch* (1867) LR 2 HL 99; *Gover’s Case* (1875) 1 Ch D 182.

<sup>106</sup> See *Smith’s Case* (1867) 2 Ch App 604; *Re London & Staffordshire Fire Insurance Company* (1883) 24 Ch D 149; *In re Pacaya Rubber and Produce Company, Limited Burns’ Application* [1914] 1 Ch 542.

considerations of materiality by reference to the same case law that is applicable to the statutory definition of materiality discussed in section 2.5 above. The remedy is available against an issuer of securities for misstatements attributed to any agent acting on behalf of the company in accordance with the scope of its authority.<sup>107</sup> As such, where the issuer is insolvent the remedy is of little assistance.

The remedy of rescission has become moribund over the last century because of significant limitations imposed by the courts on its availability. The right of rescission is lost by a shareholder if the shareholder does anything inconsistent with the right to repudiate the contract to subscribe for shares after notice of the misrepresentation is received by the shareholder.<sup>108</sup> Further, the right of rescission is lost if the parties cannot be restored to their original position.<sup>109</sup> This principle is illustrated by the loss of the right to seek rescission through the commencement of the winding up of the company.<sup>110</sup> Further, the right is lost if the shareholder does not repudiate its shares within a reasonable time of receiving notice of the misrepresentation.<sup>111</sup>

It follows from the above description that the right of rescission is only available to the person subscribing for the shares and does not extend to subsequent purchasers or to persons who subscribe through agents where they are an undisclosed principal.<sup>112</sup>

As has been discussed above, rescission was given contemporary relevance in the United States through the creation of a statutory form of rescission in Section 12(2) of the *Securities Act* 1933. The statutory remedy did away with many of the common law limitations outlined above but

<sup>107</sup> The obvious example are directors of the issuer. See *Gover's Case* (1875) 1 Ch D 182; *New Brunswick and Canada Railway & Land Company v Conybeare* (1862) 9 HL Cas 711; *Lagunas Nitrate Company v Lagunas Syndicate* [1899] 2 Ch 392.

<sup>108</sup> Examples are attempting to sell the shares, receiving dividends or paying calls - see *Re Hop and Malt Exchange & Warehouse Company, ex parte Briggs* (1866) LR 1 Eq 483; *Scholey v Venezuela Central Railway Company* (1868) LR 9 Eq 266; *Re Dunlop - Truffault Cycle Manufacturing Company, ex parte Shearman* (1896) 66 LJ Ch 25.

<sup>109</sup> *Houldsworth v City of Glasgow Bank* (1880) 5AC 317; *Smith New Court Securities Limited v Scrimgeour Vickers (Asset Management) Limited* [1994] 4 All ER 225.

<sup>110</sup> *Oakes v Turquand & Harding, Peek v Turquand & Harding, Re Overend, Gurney & Company* (1867) LR 2 HL 325; *Re Scottish Petroleum Company* (1883) 23 Ch D 413; *Reese River Silver Mining Company v Smith* (1869) LR 4 HL 64.

<sup>111</sup> *Bwlch - Y - Plwm Lead Mining Company v Baynes* (1867) LR 2 Exch 324, *Re London & Staffordshire Fire Insurance Company* (1883) 24 Ch D 149.

Delay was the fatal element in many of the early Australian prospectus cases - see In *Re The Fresh Food & Preserving Company, Limited (Smiths Case)* (1903) St R Qld 162; *Whittlesea Land Company Gutheil: Grithiffs v Whittlesea Land Company* (1892) 18 VLR 557; *Percival Johnston v Friends Motor Co Ltd* (1910) 10 CLR 365; *The Civil Service Co-operative Society of Victoria Limited v Blyth & Ors* (1913) 17 CLR 601. This is so even though the delay in question in each of these cases was within the current 3 year limitation period for the *Corporations Act* remedy.

<sup>112</sup> *Collins v Associated Greyhound Racecourses Limited* [1930] 1 Ch 1; *Duranty's Case* (1858) 26 Beav 268; *Croom's Case* (1873) LR 16 Eq 417.

imposed a negligence culpability standard for liability purposes. In the United Kingdom based jurisdictions this statutory modernisation was never undertaken.

It can be argued that the legislative creation of such a remedy is unnecessary provided the tort based statutory remedies sufficiently cover the field of securities dealings. Having regard to the scope of statutory coverage created by Part 6D.3 of the *Corporations Act* and section 1041H of the *Corporations Act* it can be argued that a statutory rescission remedy is unnecessary in Australia.

### Deceit

The traditional misstatement remedy of the common law for prospectus misstatement was of course the tort of deceit. While the tort originally developed in a fashion that might have suggested that there was scope for a flexible and effective remedy for prospectus misstatement<sup>113</sup> the usefulness of the remedy was effectively stifled through the narrow culpability standard adopted by the House of Lords a century ago in *Derry v Peek*.<sup>114</sup>

As the tort has now developed, a remedy is only available where a fraudulent misrepresentation is made to a class of persons that the defendant intends will rely on the representation and where the plaintiff in fact relies on that representation to his detriment.<sup>115</sup> The concept of fraud is limited to false representations made knowingly, without belief in its truth or recklessly careless whether the statement is true or false.<sup>116</sup>

A number of additional impediments face a plaintiff seeking to bring an action in deceit.

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<sup>113</sup> See *Burrowes v Lock* (1805) 32 ER 927; *Slim v Croucher* (1860) 42 ER 903 discussed in Davidson “*The Equitable Remedy of Compensation*” (1982) 13 MULR 349.

<sup>114</sup> *Derry v Peek* (1889) 14 AC 337. See also *Glazier v Rolls* (1889) 42 Ch D 436; *Andrews v Mockford* [1896] 1 QB 372; *Jones v Dumbrell* (1968) [1981] 1 VR 199.

For an attempt to limit the tort of deceit where a fiduciary relationship is involved see Gummow J. “*Compensation for Breach of Fiduciary Duty*”, Chapter 2 of “*Essays in Equity*” (Finn Ed) 1989 and I. E. Davidson “*The Equitable Remedy of Compensation* (1982) 13 M U L Rev 349.

<sup>115</sup> See J. G. Fleming “*The Law of Torts*” 1998, 9th Edition, Law Book Company at 703.

<sup>116</sup> Paraphrasing Lord Herschell in *Derry v Peek* (1889) 14 AC 337 at 374. For an illustration see *Knox v Hayman* (1892) 8 TLR 654.

First, the remedy is only available against the maker of a statement. As such, the remedy is only available against a person making a statement in the prospectus context, rather than persons who might have been involved in the preparation of the prospectus.<sup>117</sup>

Second, strict causation and reliance limitations have limited the prospects of a successful action being commenced in the prospectus context as discussed in Section 3.3. There are a number of other procedural and practical difficulties that the plaintiff would encounter.<sup>118</sup>

The restrictive approach of *Derry v Peek* at a time of public concern as to the losses suffered by many investors through capital raisings led directly to the legislative response of the *1890 Directors Liability Act*.<sup>119</sup> As a result of statutory remedies being developed to deal with community expectations as well as developments in the tort of negligence, the common law remedy of deceit has become moribund.

## Negligence

Liability in negligence is based on loss being suffered by a plaintiff where a duty of care is owed by the defendant to the plaintiff and that duty of care is breached.

The development of the tort of negligence and its availability in relation to misstatements that cause pure economic loss has been the most dynamic development in English and Australian tort law over the last century.<sup>120</sup> The rapid acceleration in the scope of potential liability on the basis of these cases, has resulted in a position where some commentators have suggested that there is a risk of liability in England and Australia “in an indeterminate amount for an indeterminate class”<sup>121</sup> in relation to statements disseminated to the public. As such it is not surprising to now

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<sup>117</sup> For practical examples of this principal see *Weir v Barnett & Ors* (1877) 3 Ex Div 32 (directors not liable for fraud of brokers) confirmed *Weir v Bell & Ors* (1877) 3 Ex Div 238; *Cargill v Bower* (1878) Ch D 502 (director not liable for fraud of co-director).

<sup>118</sup> For example in the prospectus context the rule in *Houldsworth v City of Glasgow Bank* (1880) 5 AC 317 requires that the plaintiff must seek rescission of the contract to take shares. Rescission may become impossible if the issuer becomes insolvent and is wound up - see *Oakes v Turquand* (1867) LR 2 HL 325. For an Australian application of these principles see *Re Dividend Fund Inc* (1974) VR 451. For discussion see *Hart* (1987) at 163-4.

<sup>119</sup> See *Gower* (1992) at 344. It has been suggested on the basis of the decision in *Nocton v Ashburton* [1914] AC 932 that *Derry v Peek* may not have necessarily completely dislodged equitable compensation for misstatement outside a fiduciary relationship - see Davidson “*The Equitable Remedy of Compensation*” (1982) MULR 349.

<sup>120</sup> The rapid development of the remedy in the last few decades can be traced through cases such as *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465; *Mutual Life & Citizens Assurance Co Ltd v Evatt* [1971] AC 973; *Shaddock v Parramatta City Council* (1981) 36 ALR 385; *Caparo Industries PLC v Dickman* [1990] 2 AC 605.

<sup>121</sup> To quote the famous words of Cardozo J in *Ultramares Corp v Touche* 174 NE 441 (1931) in the United States.

experience a “revisionist” response by the courts to the chilling effect that the expansion in the remedy has had, as demonstrated by the 1990 decision of *Caparo Industries PLC v Dickman*.<sup>122</sup>

In the *Caparo Case* it was suggested that where there is no special relationship between a defendant and a plaintiff (in that case the auditor of a company and a person who then acquired shares in the company), the imposition of a duty of care requires proximity between the parties established by foreseeability of reliance on the party responsible for the statement that is considered by the court to be fair, just and reasonable.

In the fundraising context it would seem that this proximity would be established between the issuer and its directors and persons subscribing for securities issued pursuant to a prospectus. However, the position would be less clear in fixing liability on others who may be involved in the capital raising process.

The potential difficulties associated with the use of the tort of negligence by investors in the prospectus context are illustrated by the decision of *Al-Nakib Investments (Jersey) Limited v Longcroft*.<sup>123</sup> In that case no duty of care was found to exist between the directors of a company who had issued a prospectus and made certain stock exchange announcements and purchasers of shares in secondary sale transactions on the stock exchange. Mervyn Davies J relied on the *Caparo Case* for the proposition that the special relationship required to establish a duty of care was lacking in a situation where the plaintiff is not a person who has subscribed for shares pursuant to a prospectus.<sup>124</sup>

On the other hand in *Possfund Custodian Trustee Ltd v Diamond*<sup>125</sup> it was found arguable that the necessary proximity could be established between directors responsible for a prospectus and

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<sup>122</sup> *Caparo Industries PLC v Dickman* [1990] 2 AC 605.

<sup>123</sup> *Al-Nakib Investments (Jersey) Ltd & Anor v Longcroft & Ors* [1990] 3 All ER 321.

<sup>124</sup> *Ibid* at 327.

“In the present case we have the statements in the prospectus made by the directors. It is said that the Al-Nakib company (acting by Mr Al-Nakib) in reliance on the prospectus entered into transactions 2, 3 and 4. So does a duty of care exist as between the directors and the Al-Nakib company? I would suppose that a duty of care would not be regarded as arising because Mr Al-Nakib made use of the prospectus for a purpose otherwise than for which it was issued. The prospectus was given to Comtech shareholders to enable them to consider whether or not to take up an offer of one MneMos share for every five Comtech shares at a price of 65p per share. In these circumstances there appears not to arise “the special relationship” that is referred to in the *Scott Group case* [1971] 1 NZLR 553: so that the facts pleaded do not suffice to ground any duty of care as respects transactions 2, 3 and 4.... The interim reports (whether read alone or conjoined with the prospectus) were issued for the purpose of informing the shareholder of MneMos of the activities of the company. Mr Al-Nakib used the reports as a purpose of making up his mind whether or not to buy in the market”.

To similar effect see *Peek v Gurney* (1873) LR 6HL 377 holding that no liability arises in the tort of deceit under a prospectus for persons who subsequently purchase shares in the market.

<sup>125</sup> *Possfund Custodian Trustee Ltd & Anor v Diamond & Ors (McGrigor Donald (a firm), third party); Parr & Ors v Diamond & Ors (McGrigor Donald (a firm), third party)* [1996] 2 All ER 774.

persons purchasing shares in the secondary market so as to establish a duty of care. Lightman J considered that considerations of fairness and justice would be satisfied by imposing a duty of care on directors to persons who purchased shares in the unlisted securities market within 2 months of the issue of a prospectus because one of the expressed purposes of the prospectus offering was to lead to a listing so as to permit secondary trading of the securities.<sup>126</sup> It was therefore suggested that the issue of whether a duty of care was owed sufficiently merited full consideration at trial to survive a strike-out application, notwithstanding the views expressed in the *Al-Nakib* case.

While there are significant difficulties in investors using the tort of negligence to gain direct recovery, the tort provides a much more powerful remedy for issuers (or those who subsequently control issuers or issuers in insolvency) to use the tort of negligence to claim recovery from those involved in the capital raising process.

Clearly many of the advisors to issuers undertaking a capital raising will owe a duty of care to the issuer through the proximity between the parties. This is well illustrated by the course of the NRMA litigation through the New South Wales Supreme Court in the late 1990's where the NRMA motoring organisation sought to recover the costs of its failed demutualisation<sup>127</sup> from its legal advisors claiming, among other things, negligence. At first instance, in *NRMA v Morgan*<sup>128</sup> the negligence claim was successful but on appeal in *Heydon v NRMA*<sup>129</sup> the claim failed. This precedent is illustrative of a number of high profile securities law civil actions prosecuted in Australia in the 1990's<sup>130</sup>. To the extent that targeted defendants are professional advisors (particularly accountants) with "deep pocket" insurance arrangements in place, allegations of negligent conduct are an essential element of the variety of causes of action used to assert liability to the issuer.

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<sup>126</sup> Ibid at 789.

<sup>127</sup> *NRMA Ltd & Ors v Morgan & Ors* (1999) 31 ACSR 435 (SC NSW, Giles J); *Heydon & Ors v NRMA Ltd & Ors* [2000] NSWCA 374; 36 ACSR 462 (Malcolm AJA, McPherson AJA, Ormiston AJA).

<sup>128</sup> 31 ACSR at 478-9; 733-758.

<sup>129</sup> 36 ACSR at 534-9 (Malcolm AJA); 584-5 (McPherson J); 687-694 (Ormiston AJA).

<sup>130</sup> See for example major civil litigation in the 1990s such as *Duke Group Ltd (in liq) v Pilmer & Ors* (1999) SASC 97; 31 ACSR 213 (SCSA, Doyle CJ, Duggen & Bleby JJ) (liquidator action against accounting advisors in merger); *Equiticorp Finance Ltd (in liq) v Bank of New Zealand & Ors* (1993) 11 ACSR 642 (SCNSW CA, Kirby P, Clarke & Cripps JJA) (liquidator action against financier); *Spedley Securities Ltd (in liq) v Greater Pacific Investments Pty Ltd (in liq) & Ors* (1992) 7 ACSR 155 (SCNSW, Cole J) (liquidator action to set aside transactions).

These cases illustrate that the tort of negligence, unaided by legislative assistance, is likely to be insufficiently flexible to provide the desired policy effects that underpin the mandatory prospectus disclosure regime contained in the *Corporations Act*. As such, a tort based liability regime is not a sufficient basis of regulation. As has been discussed in Section 4.3, the culpability regime now set out in the *Corporations Act* regime can be considered as analogous to that of a negligence standard.

### **Misrepresentation Acts**

As an adjunct to the tort of negligence it is worth noting the misrepresentation statutes that have been adopted by South Australia<sup>131</sup> and the Australian Capital Territory<sup>132</sup>. These statutes are based on the *Misrepresentation Act* 1967 (England) and allow recovery by a person who enters into a contract as a result of the making of a misstatement. The right is available in relation to contracts entered to with the maker of a statement, persons acting on behalf of the maker of the statement and persons who receive advantage from the making of a contract.

The remedy is available where loss is suffered as a result of making the contract and where recovery would be allowed in tort if made fraudulently. A traditionally expressed due diligence defence is available based on the defendant proving the maker of the statement had reasonable grounds to believe, and actual belief, in the truth of the representation or that the defendant did not make the statement and could not reasonably be expected to know, and did not know, that the statement was made or that it was untrue.

There is no meaningful Australian case law on these provisions. The fact that the legislation does not operate in each Australian state means that problematic conflict of law issues will arise in the securities law context.<sup>133</sup>

There is clearly a close similarity between the structure of the misrepresentation statutes and the prospectus liability provisions of Part 6D.3 of the *Corporations Act*. It can be anticipated that a case brought under both provisions would lead to similar analysis because of the close similarity in language of the due diligence defences.

### **Breach of Fiduciary Duty**

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<sup>131</sup> *Misrepresentation Act* 1971-1973 (South Australia).

<sup>132</sup> *Law Reform (Misrepresentation) Ordinance* 1977 (Australian Capital Territory).

<sup>133</sup> See *Baxt, Ford & Black* (1996) at 136.

In some fact circumstances remedies based on breach of fiduciary duty can provide a powerful civil recovery mechanism for prospectus misstatement.<sup>134</sup> These remedies, based in equity rather than the common law, are potentially more powerful and flexible than the measure of recovery for breach of tort. However the circumstances in which the remedy is available are more narrow.

An example of breach of fiduciary duty, the duty owed by a promoter to the issuer, has already been summarised above<sup>135</sup> and that law remains applicable in the current Australian context. However in the capital raising context other persons involved may owe fiduciary duties to the issuer of securities, where those duties may be enforced on behalf of the issuer. The case of *Aequitas v AEFC* is an example of such a situation where promoter liability was established, as well as a fiduciary duty owed by parties to the issuer as a financial advisor.<sup>136</sup> The existence of a fiduciary duty remains a case specific question of determining whether the vulnerability of the beneficiary in relying on the relationship with the fiduciary justifies the imposition of equitable duties.<sup>137</sup>

Significantly, if a party involved in the capital raising process owes a fiduciary duty, other persons involved in the process may face potential accessory liability based on the breach of fiduciary duty.<sup>138</sup> While the scope of this accessory liability regime is not fully settled in the Australian context, it would seem the better view is that dishonesty is required rather than simple knowledge of the circumstances surrounding the breach of duty.<sup>139</sup>

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<sup>134</sup> Noteworthy in the recent Australian context is the case of *Aequitas v AEFC* [2001] NSW 14; [2001] 19 ACLC 1,006 (SCNSW, Austin J). The case did not involve prospectus disclosure because the offerings (undertaken in the mid 1980's) had been structured to avoid the need to lodge a prospectus. However ASX compliance listing disclosure documents were prepared. The court found various persons responsible for the listing process had breached fiduciary duties owed to the issuing entities.

<sup>135</sup> See section 2.1 above.

<sup>136</sup> Citing *Daly v The Sydney Stock Exchange Ltd* (1986) 160 CLR 370 at 385 to the effect that when a person who holds himself out as having expertise in advising on investments is approached for advice on investments and undertakes to give it, in giving that advice the advisor stands in a fiduciary relationship. In *Aequitas v AEFC* the relevant entities were engaged to provide financial advice on the initial public offering, giving rise to a fiduciary duty to the issuer - see paragraphs 307 and 309.

<sup>137</sup> The leading Australian case is *Hospital Products Ltd v US Surgical Corporation* (1984) 156 CLR 41. See P.D.Finn "The Fiduciary Principle" in chapter 2 T.G. Youdan (ed) "Equity Fiduciaries & Trusts" (1989, LBC).

<sup>138</sup> This is the so called "second limb" of the rule in *Barnes v Addy* (1874) LR 9 Ch App 244 where not only the fiduciary was said to face liability for breach of duty but also any person who may "assist with knowledge in a dishonest and fraudulent design on the part of the trustee" (Lord Selbourne LC at 251). The original application to breach of trust by trustees has clearly been extended to fiduciary relationships generally - see *Consul Developments Pty Ltd v DPC Estates Pty Ltd* 132 CLR 373.

<sup>139</sup> This is the analysis of the Privy Council in *Royal Brunei Airlines v Tan* [1995] 2 AC 379. See in the Australian context the discussion and conclusions in *Aequitas v AEFC* at paragraph 383-392 and the finding of the court that *Royal Brunei Airlines* is a statement of modern Australian law.

Unlike tort liability for misstatement, the existence of a fiduciary duty does not give rise to a specified standard of care that is expected of the fiduciary.<sup>140</sup> Instead, the basic fiduciary duties are to avoid conflicts between duty and interest and to prevent profiting from the fiduciary position, unless fully informed consent is obtained from the beneficiary.<sup>141</sup> In the case of a capital raising by an issuing company, fully informed consent either requires the consent of an independent board of directors or non-affiliated shareholders.<sup>142</sup> In the case of an initial public offering this would require full disclosure in the disclosure document.<sup>143</sup>

Importantly, if a breach of fiduciary duty can be established the available remedies are potentially more powerful and flexible than is described in section 3.3 because equity seeks not so much to recoup loss suffered but to hold the fiduciary to the high duty owed to the beneficiary.<sup>144</sup> While the exact scope of the rules relating to recovery of equitable compensation are unresolved,<sup>145</sup> the normal rules of foreseeability and remoteness of loss do not apply.<sup>146</sup> Issues of causation are relevant, but the relevant test to apply is a matter of some debate.<sup>147</sup>

While the scope of breach of fiduciary duty and the nature of the equitable remedies it enlivens is a matter of interest in Australia and illustrates a developing jurisprudence, its application is only tangential to the issues within this dissertation because it does not provide investors with direct remedies for prospectus misstatement.

### Breach of Contract

As with the remedies of the tort of negligence and breach of fiduciary duty, actions based on breach of contract are potentially relevant but most likely only enforceable in the name of the issuer of the securities.

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<sup>140</sup> See *White v Jones* [1995] 2 WLR 198 and the discussion in *Aequitas v AEFC* at paragraph 283.

<sup>141</sup> *Breen v Williams* (1996) 186 CLR 71.

<sup>142</sup> *Gluckstein v Barnes* [1900] AC 240. See discussion in *Gower (1997)* at 134.

<sup>143</sup> See the finding in *Aequitas v AEFC* at paragraph 322, 334 and 363.

<sup>144</sup> *Maguire v Makaronis* (1997) 188 CLR 449 (at 465); *Warman International Limited v Dwyer* (1994) 182 CLR 544 (at 557-8) cited in *Aequitas v AEFC* at paragraph 442.

<sup>145</sup> See the discussion in *Aequitas v AEFC* at paragraph 434-468. The different types of loss identified in that case illustrate the distinction with recovery for breach of tort (at paragraphs 437-9).

<sup>146</sup> *Target Holdings Ltd v Redferns* [1996] 1 AC 421.

<sup>147</sup> See *Beach Petroleum NL v Kennedy* (1999) 48 NSWLR 1 at 90-94 and the discussion of whether the strict approach to causation espoused in *Brickenden v London Loan & Savings Co* [1934] 3 DLR 465 should be applied in Australia. In *Maguire v Makaronis* (1997) 188 CLR 449 the High Court chose not to express a view on the *Brickenden* case (at 470-4).

Many of the persons involved in the capital raising process will have privity of contract with each other, particularly the issuer of the securities. For external parties providing professional advisory services any contractual relationship is likely to contain an implied term to exercise reasonable care in the performance of the duties contracted to be provided.<sup>148</sup>

The attraction of a contractual claim in the prospectus context would be to take advantage of the benefit of the contractual measure of loss. On this basis an expectation measure of damages might be available.

Moving to the position of an investor, privity of contract will frequently exist with that issuer of securities but the difficulty will be in establishing whether any misrepresentation constituted a warranty in the relevant contract.

An example of a successful contract claim by an investor is the old case of *De Kantzow v Inglis*.<sup>149</sup> That case involved a successful claim for breach of contract against an issuer in relation to failure to fulfil the minimum subscription that was required for the issue to proceed.

The difficulties an investor will face in establishing privity of contract against others involved in the capital raising process is further demonstrated by the House of Lords decision in *Heilbut, Simons & Co v Buckleton*<sup>150</sup> where privity of contract could not be established by an investor against an underwriter. The investor had asked the underwriter if the company was a good investment. The underwriter had responded by saying that they were “bringing the company out” and it was a “good investment” for the investor. The relevant prospectus contained a misstatement as to the assets of the company.<sup>151</sup> It was argued that the underwriters statements constituted a collateral warranty to the contract of allotment for the securities. The court refused to find such a collateral contract existed on the facts.

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<sup>148</sup> See *Astley v Austrust Ltd* (1999) 73 ALJR 403 at 414.

<sup>149</sup> *De Kantzow v Inglis & Ors* (1889) 10 NSWLR (L) 297.

<sup>150</sup> *Heilbut, Simons & Co v Buckleton* [1913] AC 30.

<sup>151</sup> The number of rubber trees that the company had.

## 5.4 CRIMINAL LAW

Prospectus misstatement also gives rise to potential criminal liability under the crimes statutes of each Australian state. The scope of those criminal sanctions is similar to section 1000 of the *Corporations Act*. The statutes derive from the original English *Larceny Act* 1861.<sup>152</sup>

For example section 176 of the *Crimes Act* 1900 (NSW) provides that it is an offence for a “director” or “officer” to circulate or publish a statement:

“which he knows to be false in any material particular, with intent to deceive or defraud, any member, shareholder, or creditor, of such body corporate or company, or with intent to induce any person to become a shareholder”.<sup>153</sup>

The essential requirements of this offence are first, knowledge of a false statement and, second, intent to deceive or defraud. That standard of criminal liability is a feature of the crimes legislation in each Australian state.<sup>154</sup>

Clearly a prospectus misstatement constitutes a “statement” within the meaning of these provisions.<sup>155</sup> While the legislation does not deal with omission, a misleading impression created by an omission clearly constitutes a false statement.<sup>156</sup>

The New South Wales legislation extends to statements made recklessly. Section 178BB (inserted 1979) of the *Crimes Act* 1900 (NSW) provides that a person commits an offence if:

“with intent to obtain for himself or another person any money or valuable thing or any financial advantage of any kind whatsoever, makes or publishes ... any statement (whether or not in writing) ... which is false or misleading in a material particular and is made with reckless disregard as to whether it is true or is false or misleading in a material particular”.<sup>157</sup>

Clearly a director authorising a prospectus could be such a person. The reference to “reckless disregard” would seem to refer to reckless misstatement within the meaning of the tort of

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<sup>152</sup> The current English provision is section 19 of the *Theft Act* 1968.

<sup>153</sup> Section 176A (inserted 1979) is of even broader application - applying to any act done or omitted to be done by a director or officer “with intent to cheat or defraud” a person in dealings with a company.

<sup>154</sup> See section 191 *Crimes Act* 1958 (Vic); section 438 *Criminal Code Act* 1899 (Qld); section 192 *Criminal Law Consolidation Act* 1935 (SA); section 262 *Criminal Code Act* 1924 (Tas).

<sup>155</sup> See *R v Gurney* (1869) 11 Cox CC 414.

<sup>156</sup> See *R v Kylsant* (1932) 1 KB 442; *R v Bishirgian* (1936) 1 All ER 586; *R v M & Ors* (1980) 2 NSWLR 195. The comments made in Section 2.4 apply equally in this context.

<sup>157</sup> Section 191 of the *Crimes Act* 1958 (Vic) is to similar effect (see also section 1309(2) of the *Corporations Law*). The provisions derive from section 13 of the *Prevention of Fraud (Investments) Act* 1958 (England).

deceit.<sup>158</sup> This is likely to have a narrower ambit than that of section 1000 of the *Corporations Act* which extends to reckless disregard, whether dishonest or otherwise.<sup>159</sup>

The variety of these criminal sanctions shows the confusion of the overall criminal regime that applies to prospectuses. As has been discussed, the genesis of the inclusion of a criminal liability regime in the securities laws stem from recommendations made by the Cohen committee in 1945 and a perception that the requirement for the prosecution to prove guilty knowledge was too high a standard in the prospectus context.

Irrespective of the outcome of the debate outlined in Chapter 2 as to whether the *Corporations Act* criminal sanction reflects an appropriate degree of culpability, it is sensible that the criminal and civil remedies for prospectus misstatement are located together and are consistent in their operation. Of course, the *Crimes Act* provisions have broader application than to prospectuses (applying to any “statement”). However the overlap is a subject that is worthy of addressing in the same way as the *Misleading & Deceptive Conduct Provisions* have now been addressed as discussed above. Fortunately the overlap here sees the general provision with a narrower culpability standard than the prospectus liability standard.

A good case for the rationalisation of sanctions can therefore be made (as well as sections 999 and 1000 of the *Corporations Act*). Of course, that result would require the political support of each Australian state and is therefore more difficult to achieve than a change to the *Corporations Act*. Having regard to the developments that are reflected in the *Corporations Act*, the *Crimes Act* provisions should be considered to be an historic anachronism.

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<sup>158</sup> See *Pollard v Commonwealth Director of Public Prosecution & Anor* (1992) 8 ACSR 813 (SCNSW, Abadee J); *R v Mackinnon* [1959] 1 QB 150.

<sup>159</sup> See analysis in Section 5.2 above.

## CHAPTER 6

### CONTENT OF DISCLOSURE DOCUMENTS

A comprehensive analysis of the prospectus liability regime inevitably requires consideration of the scope of the disclosure regime that is mandated for securities offerings. Against the background of the prior policy analysis and an overview of the general approach of the *Corporations Act* to the imposition of liability, this chapter considers the general scope of the Australian disclosure regime. This chapter also involves a case study of some of the difficulties associated with a generally expressed disclosure standard as well as its interaction with the liability rules through consideration of the Australian case law on the requirement to make disclosure of the “prospects” of the issuer.

#### 6.1 DEVELOPMENT OF THE DISCLOSURE STANDARD

One of the most significant changes contained in the *Corporations Law* was the complete replacement of the disclosure standard for prospectuses from a detailed listing of specific disclosure items to be included in a prospectus to a more general and non-specific requirement of disclosure based on what the “reasonable investor” would expect to have disclosed.

##### Historical Approach

The approach of Australian and English companies legislation for much of the last century has been to require a prospectus to disclose certain prescribed information. This had commenced with the *1867 Material Contracts Act* and its mandate that material contracts entered into by the company or promoters be disclosed.<sup>1</sup> The disclosure list developed organically over this period, reflecting the perceptions of the various review bodies and legislators of the areas where investors had suffered from inadequate disclosure.

The 1981 *Companies Code* had specified 16 detailed categories of content and format requirements in section 98 and 22 detailed categories of content requirements in Schedule 4 to the *Companies Regulations*. The practice adopted by issuers in relation to prospectus preparation

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<sup>1</sup> Reflected 100 years later by section 98(1)(k) of the *Companies Code* 1981 requiring disclosure of each material contract not entered into in the ordinary course of business in the last 2 years.

and by the regulator in reviewing prospectuses was very much one of a mechanical determination as to whether the prospectus addressed those specific content and format requirements.

The legislation did however require some general disclosure based on the circumstances of the particular offering. That requirement was contained in a requirement of disclosure by the directors of circumstances which have “affected” or “will affect” the trading or profitability of the entity or the value of its assets.<sup>2</sup> In addition the regulator could specify additional requirements.<sup>3</sup> The difficulty with these requirements were that they were not specifically expressed to focus on the informational needs of recipients of a prospectus.

Against the above background the *Corporations Law* implemented a fundamentally different approach to disclosure that is general and non-prescriptive.

### **SIRC Report**

It is interesting to contrast the disclosure regime contained in the *Corporations Act* to that which had been proposed in the *SIRC Report*. The *SIRC Report* had also proposed extensive changes to the disclosure approach of the *Companies Code 1981*. The *SIRC Report* distinguished between offers made by an existing listed company or by an unlisted company to existing members or institutional investors (called class 2 regulated offers) and offers made to other persons (called class 1 regulated offers). As such a class 1 offer would correspond to an initial public offering while a class 2 offer would correspond to further public offerings or institutional offerings. The *SIRC Report* recommended that for all prospectuses a test very similar to the current Section 710 should apply based on the disclosure of “all information that would be material to an informed decision by an offeree to invest”.<sup>4</sup>

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<sup>2</sup> Regulation 21(1)(a) of Schedule 4 of the *Companies Regulations*.

<sup>3</sup> Section 98(1)(eb) of *Companies Code 1981*.

<sup>4</sup> Paragraph 4.2 of the *SIRC Report* recommended:

“That the prospectus contains all the information that would be material to an informed decision by an offeree to invest, having regard to:

- (a) the nature of the securities being offered;
- (b) the kind of persons to whom the securities are being offered;
- (c) the relationship (if any) between the offerees and the issuer; and
- (d) the general circumstances surrounding the offer.”

For the so-called class 2 regulated offers it was recommended that the general test be the only form and content prescription of the legislation. It was noted that if the issuer was listed, information already disclosed in the market need not be restated and would be deemed to be set out in the prospectus.

However for other offers additional detailed information requirements was proposed to be specified.<sup>5</sup> The objectives for that approach were said to be to require information to be disclosed in a specified sequence with a standardised format.<sup>6</sup> The *SIRC Report* further considered that the appropriate method for specifying the content requirements of prospectuses be determined by the commission through a rule making power so that the disclosure requirements be capable of adjustment to respond to changes in market practice and particular offerings that might require closer regulatory scrutiny (the example given was biotechnology and cash box companies).<sup>7</sup>

The *SIRC Report* proposals suggest an interesting reflection of what might have been, as compared to the approach reflected in the *Corporations Law* and adopted by ASIC.

## Corporations Bill

The *Corporations Bill* contained a single disclosure standard, requiring disclosure of all information

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<sup>5</sup> As set out in Appendix B to the *SIRC Report*. Appendix B of the *SIRC Report* contained detailed content and format requirement for a class 1 prospectus. Some of the more interesting proposals were as follows:

- A requirement for a discussion of the proposed business plan of the issuer, comprising a narrative report of how future operations will differ from past operations. It was suggested that this would assist investors form opinions about future operations (paragraph 6.1 of Appendix B). The possibility of including a profit forecast was referred to, but not as a mandatory requirement. If such a forecast was provided it was suggested that it be expertised.
- The practice of underwriters releasing broker reports and research reports to the market at the time of the offering was referred to (paragraph 4.4.1 of SIRC Report). It was suggested this not be restricted but, if done, should be included in the prospectus. It was noted research sometimes includes new information and comprises part of the package of information that is put together to sell the issue.
- Expert reports were considered necessary in the following areas:
  - the reasonableness of vendor consideration paid where assets are acquired from vendors (paragraph 8.1 of Appendix B);
  - the reasonableness of revaluations of assets made within 3 years (paragraph 8.2 of Appendix B);
  - legal reports on mining assets acquired, vendor contracts entered and material contracts entered in the last 2 years (paragraph 9 of Appendix B).

<sup>6</sup> It was suggested, for example, that the business description of the issuer always be found in a specified part of the prospectus. In addition, the practice of including statutorily required information at the end of the prospectus as a restatement of that statutory language was intended to be discouraged. The objective of this overall approach was to specify the contents of the whole document and to encourage narrative descriptions rather than specific statements. See paragraph 4.3 of the *SIRC Report*.

“investors and their professional advisers would reasonably require, and reasonably expect to find”<sup>8</sup>

to make an informed assessment of the financial position and “prospects” of the issuer and the terms of the securities offered (*CL* section 1022(1)).

This disclosure requirement was based on information “known to” a person with deemed primary civil liability or “it would be reasonable for such a persons to obtain by making inquiries “(*CL* section 1022(2)).<sup>9</sup> Further, regard could be had to certain information that could be considered to be generally known (*CL* section 1022(3)).<sup>10</sup>

In addition, a short list of prescribed formal matters were required for disclosure (*CL* section 1021). The most critical disclosure issue was the obligation to disclose the interest of directors and named persons in the offering (*CL* section 1021(6)).

The *Corporations Bill* broadly reflects the first of the *SIRC Report* recommendations noted above but not the second. It was suggested that the:

“Complex and excessively detailed rules as to the content of prospectuses will be replaced by much more basic disclosure rules...Despite detailed rules at present there is no guarantee that investors receive all relevant information. The amendments aim to provide investors with the information they require.”<sup>11</sup>

The assertion that the legislation assists in the identification of information to be included in the prospectus is amusing:

“The provision provides a guide to the preparers of a prospectus about what information should be included (sub-clause 1022(2)).”<sup>12</sup>

It was specifically recognised that the general provisions of section 1022 finds its source from the prospectus disclosure standard in the then *Financial Services Act 1986* of the United Kingdom.<sup>13</sup>

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<sup>7</sup> The commission’s rule making power in this area would be subject to an overriding power in the parliamentary or ministerial authority to disallow the rules. See paragraph 4.4.2 of the *SIRC Report*.

<sup>8</sup> Referred to in this Chapter as the “reasonable investor test”.

<sup>9</sup> Referred to in this Chapter as the “knowledge qualification”.

<sup>10</sup> Referred to in this chapter as the “public information qualification”.

<sup>11</sup> Paragraph 22(d) of Explanatory Memorandum to *Corporations Bill 1988*.

<sup>12</sup> Paragraph 3055 of Explanatory Memorandum to *Corporations Bill 1988*.

<sup>13</sup> Section 146 of the *Financial Service Act 1986*. The relevant provisions are now section 80 of the *Financial Services and Markets Act 2000* (for listed securities) and regulation 9 of the *Public Offer of Securities Regulations (1985)* (for unlisted securities). See paragraph 3054 of the Explanatory Memorandum to the *Corporations Bill 1988*.

In addition, it was contemplated that a regulation making power contained in the *Corporations Bill* may be used if there is a need or demand for more specific requirements to be included in prospectuses at some future stage.<sup>14</sup> However, it was stated that this power would not be exercised without consultation with affected people. In addition, it was noted that ASIC may, as the occasion requires, publish policy statements containing its views as to what should be disclosed in prospectuses which would not be binding, but would be persuasive, and may constitute guidelines relevant to ASIC's use of its stop order power.<sup>15</sup>

### Continuous Disclosure Prospectuses

In 1994, as part of the reforms associated with the imposition of potential criminal and civil liability in the *Corporations Law* to require compliance with the continuous disclosure requirements of the ASX Listing Rules and for large private companies,<sup>16</sup> a second disclosure standard became applicable to certain securities offerings. If the securities are in a class that have been quoted on ASX for more than 12 months before the issue of the prospectus then a different disclosure regime is applicable.<sup>17</sup> Under that regime the prospectus need only disclose the availability of continuous disclosure information in relation to the issuer,<sup>18</sup> the terms of the offer and (significantly), all information

“investors and their professional advisers would reasonably require, and reasonably expect to find”

to make an informed assessment of the “effect of the offer or invitation on the disclosing entity” and the terms of the securities offered (*CL* section 1022AA(2)(b)).

An important adjunct to the introduction of this section were amendments to the power to incorporate documents by reference into a prospectus. The new provision (*CL* section 1024F(1))

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Indeed, the United Kingdom provisions come from the obligations derived from membership of the European Union and the harmonized disclosure obligations arising from the securities law disclosure standards set out in EC Directive 80/390 and 89/298 (discussed in section 1.4 above). That derivation was not acknowledged in the background materials to the *Corporations Law*.

<sup>14</sup> Section 1021(7) of the then *Corporations Law*. See paragraph 3050 of the Explanatory Memorandum to the *Corporations Bill* 1988.

<sup>15</sup> See paragraph 3052 of the Explanatory Memorandum to the *Corporations Bill* 1988.

<sup>16</sup> As reflected in section 1001A-D inserted into the *Corporations Law* by *Corporations Legislation Amendment Act* 1994 (Act 31 of 1994). For background material see M. Blair “Australia's Continuous Disclosure Regime: Proposals for Change” (1992) 2 Aust Jnl of Corp L 54.

<sup>17</sup> *CL* section 1022AA(1). The issuer could not be in a class of issuer that was not entitled to use the provisions - *CL* section 1022AA(12)(c) and (d).

<sup>18</sup> *CL* section 1022AA(2)(c), (3), (4) and (5).

allowed a prospectus to be taken to include a document or part of the document for disclosure purposes if the prospectus included a summary of the document or relevant part and disclosed that the document would be provided free of charge to a person who asked for it. However, significantly, incorporation by reference was limited to a document:

“lodged under this law, under a corresponding law or under a corresponding previous law”.

This development is discussed below.

### **Simplification Task Force**

The *Simplification Task Force* did not, in terms of its plan of action, reconsider the desirability of the general prospectus content rule, but noted that the *Lonergan Committee* had indicated its support for the formulation and approach of the disclosure regime.<sup>19</sup> Indeed, in announcing the review to be undertaken by the *Simplification Task Force* the Attorney General advised that the disclosure regime would not be changed.<sup>20</sup>

However, a number of fine tuning amendments were suggested:<sup>21</sup>

- to reverse the onus of proof applicable to the making of financial forecasts (discussed in Section 6.3);
- to make various changes to the public information requirements (discussed below);
- to clarify the disclosure of interest requirements for those involved in the prospectus preparation process.

### **CLERP Act**

The *CLERP Act* more directly challenged the CL disclosure standards, with particular reference to fundraising by small and medium enterprises (“*SMEs*”) by introducing new disclosure regimes for profile statements and offer information statements, as well as by expanding the available exemptions from the need to lodge a disclosure document.

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<sup>19</sup> *Simplification Task Force Report on Fundraising* at page 12. See *Lonergan Committee Report* at paragraph 27-31.

<sup>20</sup> Attorney General’s (Mr Michael Lavarch) Press Release 27/95. This was also consistent with the recommendations of the *Wallis Committee Report* (page 265).

<sup>21</sup> *Simplification Task Force Report on Fundraising* at 12-13.

The *CLERP Fundraising Paper* noted criticisms with the existing prospectus disclosure regime that:

- Information was difficult to find, language was too technical and information was inadequate in prospectuses.<sup>22</sup>
- Most investors have difficulty understanding prospectuses as a result of their length and complexity.<sup>23</sup>
- Australian fundraising costs are higher in Australia (average of 8.3% of funds raised in 1996, 11.2% in 1995 and 7.5% in 1994) than in the United States (average of 7.1% from 1990 to 1994).<sup>24</sup>

Despite noting these concerns, no proposals to vary the general disclosure test were proposed, other than for SMEs through the offer information statement and expanded exemptions from the requirement to lodge a disclosure document. The debate of whether a checklist approach to disclosure should be preferred over a more purposive general test was noted in the paper, with the key advantage of the checklist approach said to be lower compliance costs.<sup>25</sup> However the general test was preferred as being more responsive to changes in market expectations, practices and procedures over time.<sup>26</sup>

Against this background various fine tuning changes to the structure of the legislation were made in the *CLERP Act*.

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<sup>22</sup> *CLERP Fundraising Paper* at 12 citing Communication Research Institute of Australia “*Report to Investment Funds Association and Australian Securities Commission: Developing a Performance Based Approach to Prospectuses*” March 1997 at 13-14.

<sup>23</sup> Ibid citing ASC “*Prospectus Investor Survey Report*” commissioned from Chant Link 1994 at 455-6. As discussed in Section 1.6 that is a simplistic summary of the data presented in that report. For example Chant Link concluded “overall, the majority of investors in group discussions felt than prospectuses were necessary, were usually read to some degree, but could be improved. A minority felt they were very poor as a communication tool ..... The quantitative results showed that prospectuses were seen as a very important source of information” (at 35 - 6).

<sup>24</sup> Ibid at 13 citing Price Waterhouse “*Annual Survey of Sharemarket Floats January-December 1996*” Feb 1997 and I Lee & S Lockhead “*The Costs of Raising Capital*” *Jnl of Financial Research* 1996 page 59.

<sup>25</sup> *CLERP Fundraising Paper* at 13.

<sup>26</sup> *CLERP Fundraising Paper* at 13-4 and Proposal No. 1 that “Prospectuses should disclose what investors and their professional advisers would reasonably require and expect to find in order to make an informed investment decision”.

The first change was to alter slightly the language of the reasonable requirement test to provide that the component of the test based upon what an investor and their professional advisers would “reasonably expect to find” acts to qualify the test rather than to form a component of the test.<sup>27</sup>

Second, the incorporation by reference provisions were expanded and the section heading was changed to “Prospectus Content - Shortform Prospectuses”. Instead of a document only being capable of incorporation by reference if it had been previously lodged under a requirement of the law, the new provision allows incorporation of any document “lodged with ASIC” (section 712). This proposal came from the *CLERP Fundraising Paper* and an objective to facilitate shorter prospectuses by enabling the ready incorporation by reference of all types of information.<sup>28</sup> The needs of investors were said to be addressed by requiring a description of information that it incorporated that may be of interest to retail investors.<sup>29</sup>

The *CLERP Act* therefore provides that where a document is incorporated by reference, the obligation to summarise that document in the prospectus varies depending upon whether the information is primarily of interest to professional analysts or advisers or investors with similar specialist information needs or other circumstances. If it is of professional or special interest, the prospectus must disclose that it is information of that nature and disclose a description of the contents of the document. In other cases sufficient information about the contents of the document must be included to allow a person to whom the offer is made to decide whether or not to obtain a copy of the document.

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<sup>27</sup> CA section 710(1)(a). The Explanatory Memorandum to the *CLERP Bill* stated:

“The requirement that a prospectus contain all information that investors and their professional advisers ‘expect to find’ has in practice expanded the disclosure test. For example, in practice issuers have had regard to other prospectuses and included certain types of information merely because it has been included historically or is contained in other prospectuses. This is not the intention of the provision. The words “expect to find” are intended to limit, and not expand, the disclosure test” (paragraph 8.5).

The need for this change based on the above argument is open to some conjecture - see *Black, Bostock, Golding & Healey (2000)* at paragraph 2.45 and *Hone (1998)* at 312. The subtlety of the distinction is unlikely to amount to a significant difference in the requirements of the disclosure standard.

<sup>28</sup> *CLERP Fundraising Paper* at 16.

<sup>29</sup> As such, Proposal No. 2 was that:

“Prospectuses should be shorter and more useful to retail investors. This can be achieved by allowing issuers to provide retail investors with the information which will assist them, without unnecessary details. Additional information, which may primarily be of interest to professional analysts and advisers, can be mentioned in the prospectus and made available free of charge to those who request it.”

## 6.2 GENERAL ANALYSIS OF THE DISCLOSURE TESTS

Against the above background the disclosure standards set out in the *Corporations Act* for offering documents can be considered.

### The Reasonable Investor Test

The general content requirements of section 710 of the *Corporations Act*, the so-called reasonable investor test, is apparently straightforward in its terms.

The test focuses on a requirement of disclosure of information that investors and their professional advisers would “reasonably require” in a prospectus. The information is information relevant to the purpose of making an informed assessment of the assets and liabilities, financial position, profits and losses and, importantly, “prospects” of the issuer as well as the rights attaching to its securities. In addition to the general disclosure standard, a prospectus must set out certain specified matters as provided for in section 711. The areas of specific disclosure are very narrow and do not extend to any matters that would be directly relevant to an assessment of the value or attractiveness of the securities being offered. As such, the provisions should not be seen to aid an appreciation of the operation of the general standard of disclosure.<sup>30</sup>

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<sup>30</sup> The prospectus must set out the terms and conditions of the offer (section 711(1)).

Disclosure of interests in relation to the offering must be made by certain specified persons. Those persons are as follows (section 711(4)):

- directors and proposed directors;
- persons named in the prospectus as performing a function in a professional advisory or other capacity in connection with the preparation or distribution of the prospectus;
- promoters (It is odd that ‘promoter’ has been removed from many of the fundraising provisions (see for example removal of specific liability regime for promoters) though retained for this limited purpose. The definition of ‘promoter’ has been omitted from section 9. The case law on the fiduciary duty owed by promoters to companies will provide assistance in defining the term. For analysis see Section 3.1);
- stockbrokers or underwriters but not sub-underwriters.

In regard to each of these disclosing persons, the prospectus must set out, in relation to the formation or promotion of the body and the offer of the securities:

- the nature and extent of interests that the person holds or held at any time during the last two years (section 711(2)(a), (c)); and
- the amount that anyone has paid or agreed to pay, or the nature and value of any benefit anyone has given or agreed to give, for services provided by the disclosing person (section 711(3)(b)).

The prospectus must set out the nature and interests that these disclosing persons hold or held at any time during the last two years in property acquired or proposed to be acquired by the body in connection with its formation or promotion or the offer of securities.

The prospectus must further set out the amount that anyone has paid or agreed to pay or the nature and value of any benefit anyone has given or agreed to give to a director or proposed director to induce them to become or to qualify as a director of the body.

As noted above, at the time of enactment of the *Corporations Law* it was contemplated that guidance as to the content of offering documents might be provided through the regulation making power in the legislation or by way of ASIC policy statements.

The legislature has shown no interest in using its regulation making power. In addition, from the very outset of the introduction of the *Corporations Law*, ASIC backed away from providing any guidance as to how the disclosure standard should be interpreted, or from having any involvement in developing standards for the content of prospectuses. In its initial policy statement on the prospectus provisions of the *Corporations Law*,<sup>31</sup> ASIC stated:

- It will not under any circumstances use any of its powers to introduce checklists for prospectuses; and
- It will not consider or provide advice on draft prospectuses.

Instead, the focus of ASIC has been to devote resources to enforcement of prospectuses and post-vetting review rather than pre-vetting. This position has continued following the enactment of the *CLERP Act*. ASIC would not have appeared to have seen any need over the last decade to revisit that view.

The effect of the above changes is that in Australia over the last two decades the Australian regulator has surrendered its role as a key gatekeeper in ensuring the adequacy of disclosure before a disclosure document is available to investors. This contrasts with markets such as the United States where the SEC continues to be seen as having a valuable role to perform in protecting the public through a comprehensive review of disclosure documents before a final investment decision is made.<sup>32</sup>

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An issue unresolved by the legislation is whether the concept of formation or promotion applies only to the original establishment of a company or will extend to the raising of fresh capital by an established company. General law authority would suggest that only the initial steps of capital raising are contemplated by the concept of promotion (*Emma Silver Mining Coy v Lewis* (1879) 4 CPD 396; *Tracy v Mandalay Pty Ltd* (1952) 88 CLR 215). However, ASIC adopted a broader view under former s 1021(6) (See ASIC Practice Note 55, paragraph 55). On the other hand, the further requirement of disclosure of interests in relation to the offer of securities in the new section now renders this debate largely irrelevant.

The obligation to disclose amounts paid and the value of benefits given as outlined above extends beyond amounts and benefits provided by the offeror (the reference to 'anyone'). In addition, the legislation provides that it is not sufficient merely to state in the prospectus whether a person has been paid or will be paid normal, usual or standard fees.

<sup>31</sup> ASIC Policy Statement 2 issued 26 April 1991, now superseded. See paragraph 46.

<sup>32</sup> For advocacy of this role see for example A. Poliakoff "SEC Review: Comfort or Illusion?" (1987) 17 Uni of Balt L Rev 40 and *Coffee* (1997) at footnote 59. Compare *Langevoort* (2001) at 4 (arguing that a government agency is not suited to such a task).

While this approach offers regulatory cost savings and improves efficiency by reducing the time required to prepare a disclosure document, there has been little analysis in Australia as to whether the quality of disclosure documents have suffered. This may be an issue that should be reflected on following the events of 2000 - 2001.

### General Disclosure Standard

The difficulty with this approach is the indeterminacy that arises as a result. That indeterminacy is seen in the case law that is analysed in Section 6.3 below. The expression of the disclosure standard in this way is a classic example of a so called “mud rule” or “fuzzy” law in that the standard lacks specificity but sets a standard that can be used as a basis for setting acceptable norms of behavior through later court determinations.<sup>33</sup>

As noted above, the original *CL* section 1022 disclosure standard was modeled on the English *Financial Services Act*, which itself is based on the European Union Directives in relation to securities offerings. However, in the English model (and the model adopted by other securities exchanges in the European Community), the disclosure standard does not sit alone. For a company seeking listing on the London Stock Exchange, assistance is obtained in establishing the requirements for disclosure through the very prescriptive requirements of the London Stock Exchange.<sup>34</sup> No such regime assists in the Australian context.

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<sup>33</sup> See C. Rose “*Crystals and Mud in Property Law*” (1988) 40 *Stanf L Rev* 577, discussed in J. Hill “*Visions and Revisions of the Shareholder*” (2000) 48 *Am Jnl of Comp Law* 39 at 67 - 69 and *Whincop* (1999). A crystal rule is one that provides for sharp boundaries defining prescribed conduct and allowing little discretion for the decision maker while a mud rule provides a hazy penumbra requiring the ex post application of judicial discretion.

The debate was reflected in the early 1990’s through advocacy of using “fuzzy law” in the *Corporations Act* context - J. Green “*Corporate Crooks*” (1990) 8 *C&SLJ* 414; J. Green “*Fuzzy Law - A Better Way to Stop Snouts in the Trough?*” (1991) 9 *C&SLJ* 144 and see *Whincop* (1999) at 19 - 25.

<sup>34</sup> Chapter 6 of the Listing Rules of the UK Listing Authority. In the case of unlisted securities the general test is aided by the prescriptive requirements of Schedule 1 to the *Public Offer of Securities Regulations* 1995 (comprising 51 disclosure items to be addressed).

Further, the Proposed Directive released by the EU in 2001 (see footnote 160 to Chapter 1) contemplates an extensive disclosure regime in aid of the general disclosure standard (Article 5 and Annex 1). The reason for this change was expressed to be “enhanced disclosure standards in line with international standards” (section 1 of the Explanatory Memorandum).

The contrast to Australia is clear.

Further, the Proposed Directive released by the EU in 2001 (see footnote 160 to Chapter 1) contemplates an extensive disclosure regime in aid of the general disclosure standard (Article 5 and Annex 1). The reason for this change was expressed to be “enhanced disclosure standards in line with international standards” (section 1 of Explanatory Memorandum).

The contrast to Australia is clear.

In the United States context a similar position applies, where detailed disclosure requirements are highly prescriptive<sup>35</sup>. In addition, there is a general test of disclosure of additional material information that underpins the prospectus laws<sup>36</sup>. In that regard, the United States position is analogous to the position that existed prior to the enactment of the *Corporations Law* in Australia, but with a much higher degree of sensitivity as to the override that a prospectus must include all material information. In addition, the formal requirements of disclosure are probably more prescriptive than in any other jurisdiction.

That approach is also consistent with the approach adopted in most other significant international jurisdictions.<sup>37</sup> As such, the Australian approach is at odds with international practice.<sup>38</sup>

Such an inconsistency of approach should cause pause for thought in the Australian context. However, that has not been the experience over the last decade, either by the regulators, review bodies or politicians.

The difficulty with the Australian approach is that it is dependant on a deep and well established capital market that clearly communicates its information requirements to issuers. The Australian capital markets are very small by international standards with relatively few IPOs compared to markets such as the United States and the EC.

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<sup>35</sup> See for example the extremely detailed disclosure criteria set out in Regulation SK promulgated under the *Securities Act 1933*.

<sup>36</sup> Rule 408 promulgated under the *Securities Act 1933* requires disclosure of "such further material information ... as may be necessary to make the required statement, in light of the circumstances ... not misleading".

<sup>37</sup> In Canada a prospectus must provide "full, true and plain disclosure of all material facts". A material fact is a fact that "significantly affects, or would reasonably be expected to have a significant effect on the market price or value of securities". See *Ontario Securities Act RSO 1990* section 56(1); *Alberta Securities Act SA 1981* section 84(1); *British Columbia Securities Act RSBC 1996* section 631(1). The general test is elaborated on in great detail in the regulations for different types of issuers - see the description in *Johnson & Rockwell (1998)* at 74 - 7. This standard is considered to impose an obligation to present information in a straightforward narrative and plain english style and to include all facts that significantly affect or would reasonably be expected to have a significant effect on the market price or value of securities - see *Rousseau (2000)* at 670.

In Commonwealth countries the pre *Corporations Act* approach continues - see the prescriptive requirements of section 39 of the *Securities Act 1978* and the schedules to the *Securities Regulations* in New Zealand (with a general requirement to disclose other "material matters" (for example in clause 40 of schedule 1)) and the prescriptive requirements of section 38 of the *Companies Ordinance (CAP 32)* and the third schedule in Hong Kong.

An interesting contrast is Singapore which moved in 2001 to adopt the Australian disclosure standard (section 45 of the *Companies Act (CAP 50)*). However, in doing so it retained a modified list of specific disclosure requirements in addition to the general standard (see section 45(1)(b) and Fifth Schedule).

<sup>38</sup> The same observation is made in *Hone (1998)* at 312.

For an illustration of an eminent Australian judge expressing the view that securities legislation that sketches broad outlines while leaving judges to fill in the detail is not likely to be effective see A. Mason "*Corporate Law: The Challenge of Complexity*" (1992) 2 Aust Jnl of Corp L 1 at 2.

A further difficulty with this approach is that the approach turns its back on the work of the review committee's that established the modern prospectus laws. The most cursory review of the English review committee's that shaped the Australian/English regime as outlined in Section 1.4 reveal an ongoing process where it was considered that specification of particular disclosure matters was necessary because of a history of market deficiencies in disclosure that had been encountered over time.

In one sense the Australian standard reflects an endorsement of the arguments presented by the information economists. It is left to the market to determine the content of disclosure. However, in a perverse twist to that argument, the legislation mandatorily requires that the information required by the market in the circumstances of the particular offering must be disclosed. Of course, the information economists would not have a section 710 test at all (except perhaps for the comparative disclosures suggested by Easterbrook & Fishel).<sup>39</sup>

The Australian experience over the last 10 years with a test that purports to be purely market driven would provide an interesting point of analysis in assessing the validity of the arguments of the information economists and their critics.<sup>40</sup> From a practitioners perspective the experience has been more detailed disclosure documents rather than less detailed disclosure documents since the enactment of the *Corporations Law*. While there are likely to be a number of factors contributing to that,<sup>41</sup> one of the possible factors is that the indeterminacy of the disclosure standard encourages over disclosure rather than under disclosure. That proposition is tested in this dissertation by the case study analysis of Section 6.3. The narrowing of the disclosure test by the *CLERP Act* referred to above is unlikely to assist because the difficulty arises not from the formal words of the test but from the indeterminacy of the basic concepts used.<sup>42</sup>

A possible consequence that arises in these circumstances is that costs instead increase rather than decrease as a result of the indeterminacy, undermining the objectives of reduced costs claimed in the background materials to the *CLERP Act*.

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<sup>39</sup> For advocacy of this view in the development of the *CLERP Act* legislation see *Corbett (1999)* at 526.

<sup>40</sup> That of course, is not the objective of this dissertation.

<sup>41</sup> Additional factors are likely to include the increasing globalisation of securities markets causing greater influence of foreign practices on the Australian approach (for example increasing management, discussion and analysis disclosures as required by Regulation SK promulgated by the SEC) and greater institutional influence on prospectus pricing.

<sup>42</sup> In that regard it should be noted that the case law subject to analysis in Section 6.3 does not refer to this distinction.

### The Knowledge Qualifications and Public Information Qualifications

A proper understanding of the general disclosure regime requires regard to be had not only to the reasonable investor test but also to the knowledge and public information qualifications contained in sections 710(2) and (3) of the *Corporations Act*.<sup>43</sup>

As originally formulated, the knowledge qualifications were based on the knowledge of those with primary civil liability under the then section 1006(2) of the *Corporations Law*. With the enactment of the *CLERP Act* this correlation has moved slightly out of alignment through the list of persons whose knowledge is relevant not quite correlating with those named as having primary liability.<sup>44</sup> This would appear to be drafting anomaly instead of a deliberate policy proposal.

With the enactment of the *CLERP Act*, significant changes have been made to the public information qualifications. Under the original formulation of the *Corporations Law*, regard could be had to the following factors for the purposes of assessing what information was required to be disclosed:

- (a) the nature of the securities in question and the issuer;
- (b) the kinds of persons likely to consider buying the securities;
- (c) the fact that certain matters may reasonably be expected to be known to professional advisers of any kind who investors may reasonably be expected to consult;
- (d) whether the persons to whom the offer is to be made are the holders of shares in the issuer and, if they are, the extent to which relevant information has previously been given to them by the issuer under any law, any requirement of the business rules or listing rules of Australian Stock Exchange Limited, or otherwise; and
- (e) any information known to investors or their professional advisers by virtue of any Australian legislation.

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<sup>43</sup> For analysis see G. Golding & T. Bancroft “*Secondary Sale Prospectuses: What Do I Disclose When I Know Nothing?*” (1993) BCLB para 427.

<sup>44</sup> Under section 710(3)(d) and (e) the knowledge of an underwriter and a stockbroker are relevant. Under section 729(1) it is only an underwriter (and not a sub-underwriter) who has primary civil liability. Therefore the knowledge of stockbrokers who are not underwriters is relevant - see Chapter 8. For the reasons set out in Chapter 8, it would not seem sound as a matter of policy to require the knowledge of such persons to be relevant for disclosure purposes. Knowledge of a person should only be relevant to the extent that they are involved in the prospectus preparation process.

It was clear that the original drafting of those provisions was unsatisfactory.<sup>45</sup>

For example:

- paragraph (c) and (e) appeared to largely cover the same ground;
- It was not clear what was intended in paragraph (e) through the requirement that the information be “known” by virtue of an Australian law.
- The reason for restricting the qualification to information known to advisers was also unclear. Surely if investors in the market were generally aware of information that should be sufficient.

A further difficulty was that case law suggests that courts may be reluctant to assume that information that is generally available to investors need not be disclosed in disclosure materials.

For example, in *Pancontinental v Goldfields*,<sup>46</sup> a takeover document was challenged on the ground that there was insufficient disclosure of the political risks associated with mining operations of the bidder in Papua New Guinea (the bidder was offering its scrip in exchange for the target company shares). The argument was put by the bidder in response to this allegation that the unrests and risks associated with the conduct of mining operations in Papua New Guinea were the subject of widespread publicity in the Australian press. Tamberlin J refused to accept that argument and indicated that in circumstances where the target company had no operations in New Guinea, it could not be readily assumed that investors will be up-to-date with their knowledge of the political and investment scene in New Guinea.<sup>47</sup>

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<sup>45</sup> See *Golding & Bancroft supra*.

<sup>46</sup> *Pancontinental Mining Ltd v Goldfields Ltd* (1995) 16 ACSR 463 (FCA, Tamberlin J).

<sup>47</sup> *Ibid* at 481.

Similarly, in the earlier case of *ICAL v County NatWest* (1988) 13 ACLR 129 a question arose as to the adequacy of disclosure in a takeover document of ministerial announcements concerning the affairs of the target that had previously been disclosed to shareholders of the target. Despite the judge’s finding that many shareholders in the target would have come to know the information, particularly if they had a professional investment manager, the view was expressed that it was probable that a very significant number of target shareholders did not know of the announcement and the fact that information had been published by the Government and had been the subject of news reports, was not significant because much information in the public domain fails to reach many members of the public. It was considered that:

“Dissemination by news media would be significant only if it carried matters to the point that it was probable that all the holders of shares in the plaintiff had had the joint communicae disclosed to them in that way; and I find this is not probable.” (at 141).

*The Simplification Task Force* identified some of the deficiencies in drafting referred to above. However, their recommendation was to narrow the scope of the public information qualification.

It was suggested that the paragraph (d) exception for information previously disclosed be deleted because of the introduction of the continuous disclosure prospectus and the incorporation by reference provisions.<sup>48</sup> In addition, the exception for information made available to investors under any law under paragraph (e) was considered to be incorrect in principal because it was suggested that information should be made available in the prospectus if it is reasonably required by investors to make an informed decision about the offer.<sup>49</sup>

As a consequence, following the enactment of *CLERP*, the public information qualification is limited to:

- (a) the nature of the securities and of the body;
- (b) the matters that prospective investors may reasonably be expected to know;
- (c) the fact that certain matters may reasonably be expected to be known to their professional advisers.

The public information qualification invites a debate on the efficient market hypothesis as the philosophical premise of the qualification must be that it is not efficient to require the disclosure of information to the extent the information is known and will be reflected in securities prices. However, the existence of this policy debate or questions as to its validity were not raised in any of the background materials leading up to the enactment of the *Corporations Law* or the *CLERP Act*. That is a missed opportunity because, if the public information qualification was approached from this perspective, a more coherent disclosure standard may have developed.

The lesson of the analysis from Section 1.6 is that an understanding of market efficiency requires regard to be had to the market mechanisms by which efficiency is achieved.<sup>50</sup> The objective

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<sup>48</sup> See *Simplification Task Force Report on Fundraising* at page 13. It was also asserted that in practice the person issuing prospectuses were reluctant to omit information based on this provision because of uncertainties about its meaning.

<sup>49</sup> *Simplification Task Force Report on Fundraising* at page 13. It was also noted that the effect of the provision is uncertain and that on one view it would enable relevant statutory provisions to be omitted while on another view it would enable information made available to investors under any law to be excluded from prospectuses. For the reasons outlined above this author prefers the second meaning.

<sup>50</sup> See Section 1.6 at text accompanying footnotes 239 to 244.

should be to ensure that information costs are minimised<sup>51</sup> having regard to those market mechanisms. Against that background the objective of the legislation should be to ensure that, while relevant information be widely available to all, it be delivered in the most cost-effective fashion to the professional traders who most efficiently drive prices. In Australia the market significance of institutional investors is undoubtedly a key influence. For this reason the initiative of the *CLERP Act* in broadening the ability to incorporate previously disclosed information by reference, particularly for material of primary interest to professional investors, is a very positive development.<sup>52</sup>

Based on this approach, the Australian regime would similarly be assisted by remolding the public information qualification so that it permitted regard to clearly be had to:

- Information that can be reasonably be expected to be known to all investors.
- Information previously disseminated by the issuer to all of its investors and generally publicly available.
- Information concerning industry and non-issuer specific matters that could reasonably be expected to be known to professional investors and generally publicly available.

The above analysis is based on acceptance of concepts of market efficiency as an appropriate paradigm for disclosure purposes.<sup>53</sup> The question is how should the disclosure regime deal with the real possibility of noise. Again, there is a complete absence of these considerations in the background materials leading up to the enactment of the *Corporations Law* and the *CLERP Act*.

It would seem that the solution would be for the disclosure regime to build into its structure devices that address some of the heuristics and biases that may cause irrational behavior, as an override to the provisions that are reflective of principles of market efficiency. For example disclosures that are not very recent but are key to investment decisions might be required to be

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<sup>51</sup> Being the costs for traders in acquiring, processing and verifying information.

<sup>52</sup> Subject to reservations about the indeterminacy of the distinction between information that is of primary interest to professional investors and that which is not.

<sup>53</sup> By way of contrast, in the United States such an approach is reflected in the jurisprudence. For example in *Apple Computer Securities Litigation* 886 F 2d 1109 (9th Cir 1989) a failure to disclose material information was excused where it has “credibly” been disclosed to the market from other sources (at 1115).

These issues also feed into the theory described in the United States as “mosaic misrepresentation theory” where information disclosed to the market should properly be considered as part of a mosaic to determine if a misstatement has arisen - see cases such as *Isquith v Middle S Utilities, Inc* 847 F 2d 186 (5th Cir 1988) at 200; *Genentech, Inc Securities Litigation* 1989 Fed Sec L Rep (CCH) 94,544 (ND Cal 1989).

prominently noted or repeated. In addition, a power could be introduced for ASIC to require disclosure of specified information that is sector or market specific where it has concerns that speculative bubbles are building so that investors have prominently before them information that may counter some of the market sentiment that may drive markets to be irrational.<sup>54</sup> While such powers might not be sufficient to modify the irrationality of the market from time to time, it would certainly provide a better response than complete inaction in dealing with some of the perceived causes of market irrationality.<sup>55</sup> Having made these comments it is interesting to reflect on the proposals made by the *SIRC Committee* described above. The adoption of those proposals would more closely have accorded with these principles than are provided for in the current approach of the *Corporations Act* and the regulatory role that has been assumed by ASIC.

The above analysis is not to suggest that the views expressed are clear solutions or even the correct approach that should be adopted. As Section 1.6 demonstrates the debate on the impact of market efficiency and noise is clearly unresolved. The analysis is instead intended to demonstrate that if a debate had been entered as to how these policy considerations should have been dealt with in the legislation, it is likely that better quality legislation would have been generated.

### Specific Disclosure Requirements

In addition to the general disclosure standard, a prospectus must set out certain specified matters as provided for in section 711.

The areas of specific disclosure are very narrow and do not extend to any matters that would be directly relevant to an assessment of the value or attractiveness of the securities being offered. As such, the provisions should not be seen to aid an appreciation of the operation of the general standard of disclosure.

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<sup>54</sup> Of course ASIC would also have to be directed to use this power having regard to the view it has adopted since the enactment of the *Corporations Law* that it should not intrude on disclosure issues.

<sup>55</sup> One observation that is likely to be made in future inquiries as to features of the new economy boom and subsequent tech-wreck is the flotation and public listing of companies that did not have a track record of performance and ultimately were found not to have sound business plans.

A study of boom and bust in the stock market demonstrates that bubble markets frequently involve the flotation of untried companies that, with hindsight, are likely to be investments where many investors have not sufficiently understood the risk being assumed - for example see this observation made in the early 1960s by *Knauss (1964)* at 617 in relation to companies listed in the United States between 1952 - 1962. See also J. Ritter "*The Long Run Performance of Initial Public Offerings*" (1991) 46 *J Fin* 3. In this situation promoters and professional advisors have considerable commercial incentives to pursue such listings.

### Continuous Disclosure Prospectuses

If the public information qualifications described above operated in an effective manner it can be suggested that there was no need to introduce the continuous disclosure prospectus standard. The general disclosure tests should have the inherent flexibility to meet the differing circumstances of a company offering securities at a time when it is a listed entity making disclosure to the market in accordance with the continuous disclosure requirements of the *Corporations Act*, as distinct from a company issuing securities at a time when it has no investor following.

Prospectuses for the offering of listed securities are largely unchanged from the pre-*CLERP Act Corporations Law*. Where the necessary pre-conditions relating to an offer for continuously quoted securities (or options in relation to such securities) are satisfied the prospectus need only disclose all the information investors and their professional advisers would reasonably require on (section 713(2)):

- the effect of the offer on the issuer; and
- the rights and liabilities attaching to the relevant securities.

Access to relevant documents lodged under the continuous disclosure requirements of the *Corporations Act* must be provided: section 713(4).<sup>56</sup> Information not previously disclosed because of its confidential or prejudicial nature under the continuous disclosure regime must be disclosed if otherwise required to satisfy the general prospectus disclosure test: section 713(5).

For purposes of the above requirements, continuously quoted securities are securities that were quoted ED securities at all times in the previous 12 months and were not covered by certain exemptions: section 9 (definition). The term ED securities is defined in Pt 1.2A (section 111AD) to be securities of widely held entities.<sup>57</sup>

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The challenge for the legislature and the regulator is to propose regulatory models, without resorting to merit legislation, that will appropriately deal with such market conditions (*Knauss (1964)* advocated merit legislation in such a situation at 620).

<sup>56</sup> A copy must be provided free of charge to anyone who asks for it or the prospectus must be accompanied by a copy of the most recently lodged annual financial report, any half year financial report since the most recent annual financial report and any continuous disclosure notices released since the time of the most recent annual financial report.

<sup>57</sup> Those entities are securities:

- quoted on the stock market of a stock exchange (section 111AE); or

It is clear that the s 713 standard of disclosure is less rigorous than the general prospectus disclosure standard.<sup>58</sup>

The *CLERP Fundraising Paper* endorsed the continued availability of this reduced disclosure standard on the basis that “market reaction to date” suggests the current law was working effectively and had resulted in shorter and easier to produce prospectuses.<sup>59</sup> The *CLERP Fundraising Paper* posed the question of whether a prospectus should be required for a rights issue. It was noted that a concessional disclosure regime applies in the United States and Ontario<sup>60</sup> but that a complete exclusion from the prospectus requirements is available in New Zealand.<sup>61</sup> On the other hand a full prospectus is required in the United Kingdom.<sup>62</sup>

The *CLERP Fundraising Paper* opted for requiring a prospectus, even though some costs and time delays are imposed on the issuer, because it was considered that removing the requirement for a prospectus could result in material information not being provided to investors, even if continuous disclosure obligations have potential application.<sup>63</sup> The carve out for continuous disclosure obligations in relation to the disclosure of confidential information was noted in this regard.

The clear unexpressed policy premise of the section 713 standard of disclosure is market efficiency. What the *CLERP Fundraising Paper* and the 1994 amendments to the *Corporations Law* did not do is to critically analyse the reduced disclosure standards by reference to the theoretical underpinnings of market efficiency, as discussed in Section 1.6. This contrasts with

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- issued under a prospectus where more than 100 people have held the securities (section 111AF); or
  - issued as consideration under a takeover where 100 people have held the securities (section 111AG); or
  - debentures where a trustee is required to be appointed: (s 111AI).

<sup>58</sup> See statements to this effect in *Re Primac Holdings Ltd* (1996) 22 ACSR 212 at 214. In *Solomon Pacific Resources NL v Acacia Resources Ltd* (1996) 19 ACSR 238 at 241, it was noted that the obligation to make disclosure of the rights attaching to securities refers only to the legal incidents of ownership of the securities and does not include a requirement to disclose details of the value of the securities.

<sup>59</sup> *CLERP Fundraising Paper* at 29 - 30. Proposal No 6 was that “Prospectuses should be required for rights issues but should be limited to information about the transaction and other information not already disclosed to the market”.

<sup>60</sup> SEC Form S3 (United States) and section 73 of the *Ontario Securities Act* (Ontario).

<sup>61</sup> Section 6 of the *Securities Act* (New Zealand).

<sup>62</sup> Regulation 5 of *The Public Offer of Securities Regulations (UK)*.

<sup>63</sup> *CLERP Fundraising Paper* at 30 - 1.

the introduction of shelf registration in the United States where issues of market efficiency were vigorously debated.<sup>64</sup>

For example, the question of market efficiency of Australian companies, particularly smaller capitalised Australian companies, was not discussed. By way of contrast, in the United States, the reduced disclosure standard is only available if freely traded securities of the issuer exceed US\$75 million.<sup>65</sup> This requirement is suggested as the minimum market capitalisation before an issuer has a meaningful analyst following, resulting in market efficiency. It has been noted that the small size of the Australian capital markets means that there may be less efficiency in the Australian markets as compared to larger markets. The adoption of the Australian standard was never explicitly linked to a debate of market efficiency. Instead the change was seen as a political quid as a trade-off for expanded liability for continuous disclosure obligations in the *Corporations Act*.

A further difficulty with the Australian approach is that there has been no debate as to the interaction of the liability regime and the information assumed to be generally known in relation to the prospectus. In the United States each person with statutory responsibility for a prospectus has liability for all statements made in the periodic and continuous disclosure documents that are assumed to form the basis of the prospectus.<sup>66</sup>

It has been suggested in the United States that this liability regime reflects a degree of lip-service to market efficiency because the refusal to release underwriters from liability for incorporated statements acts to enhance the care taken in relation to incorporated statements.<sup>67</sup> The issue that arises is whether it is fair to impose that liability on the underwriter having regard to the limited opportunity available to it to conduct due diligence and to verify prior securities law filings.<sup>68</sup>

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<sup>64</sup> See for example the analysis of the time in *Greene (1981)*; *Banoff (1984)*; *Fox (1984)*; Unfortunately, that debate reflected a fairly slavish support for principles of market efficiency (clearly a reflection of the orthodox analysis in the academic literature at that time, as noted in Section 1.6).

<sup>65</sup> General Instruction BI to Form S - 3 promulgated under the *Securities Act 1933*.

<sup>66</sup> See *Pickholz & Horahan (1982)* at 947 - 956. This is critical because a lower standard of culpability applies to those disclosures. Imposing greater culpability standards on periodic and continuous disclosures may be a logical response - see *Fox (1984)* and *Knauss (1964)* at 627 - 8. See also section 1704 of the *ALI Federal Code* (directors and management would face damages, subject to a due diligence defence, for annual reports).

<sup>67</sup> *Pickholz & Horahan (1982)* at 947; *Note (1983)* at 780 - 2.

<sup>68</sup> *Greene (1981)* at 61; *Nicholas (1983)* at 15; *Langevoort (1985)* at 774 - 6; *Frerichs (1989)* at 394 - 5; *Note (1989)* at 801; *Choi (1997)* at 567 - 78; *Langevoort (2000)* at 65 - 7.

Some authors have argued that the costs associated with due diligence inquiries are not justified from a theoretical perspective because theories of market efficiency and portfolio theory should adequately protect investors.<sup>69</sup> Other authors are critical of this view, pointing to the role of liability rules in ensuring allocative efficiency through prices reflecting correct information.<sup>70</sup> The former view overlooks the important role played by liability rules in reducing verification costs for the market.<sup>71</sup>

In Australia no such liability is assumed under section 729 of the *Corporations Act*. There has been no analysis of the merits, or otherwise, of that approach. For example it is axiomatic that market efficiency is unlikely to discriminate between true and false information. Therefore the securities laws are not necessarily served by releasing key persons involved in the capital raising process from liability for incorporated documents.<sup>72</sup>

### Offer Information Statements

Offer Information Statements (OISs) are an initiative of the *CLERP Act* intended to facilitate fundraising by small and medium enterprises (SMEs).

A body offering securities may use an OIS for the offer instead of a prospectus if certain preconditions are satisfied. The consequence is that such a body may elect to choose between using a general prospectus and an OIS where it satisfies the relevant qualifications.

The *CLERP* program asserted that the availability of funding to SMEs is central to the viability of the Australian economy and that the cost of issuing prospectuses for SMEs is excessive.

Regard was had to an industry commissioned report to the effect that SMEs play a valuable role in the economy because they are better able to adjust output levels when demand fluctuates over

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<sup>69</sup> See particularly *Banoff (1984)* at 176 - 84; *Note (1989)*; *Choi (1998)* at 964. In Australia see *Azzi (1991)* at 208 - 9 and *Herder (1995)* at 188 - 9.

*Coffee (1995)* argues that the difficulties associated with shelf registration has encouraged the development of the "bought deal" distribution mechanism (direct sale by the issuer to a group of institutions) (at 1170).

<sup>70</sup> See *Note (1983)* at 779 - 782; *Fox (1984)*; *Fox (1997)* at 912.

<sup>71</sup> See discussion in Chapter 1 at text accompanying footnote 228.

<sup>72</sup> See *Greene (1981)* at 796 - 7 and the proposed safe harbour for liability discussed at the time in relation to incorporated documents at 800 -7.

time and may have superior access to some scarce factors of production such as specialised knowledge or an ability to serve a particular market well.<sup>73</sup>

The difficulties encountered by SMEs in obtaining access to external capital was explained by reasons such as inefficiencies in the Australian SMEs capital market, lack of business management skills and corporate governance arrangements in SMEs, the small size of SMEs and the risk associated with SMEs.<sup>74</sup> Data was presented that the high fixed costs associated with fundraising means that the proportion of expenditure required by an SME in raising equity pursuant to a prospectus was much higher than for other issuers.<sup>75</sup>

It was against this background that the proposal was made that the OIS mechanism be available, as well as the availability of expanded exemptions from the obligation to lodge a prospectus where offers are made to certain perceived experienced investors.<sup>76</sup>

The relevant criteria for the use of an OIS is that the amount of money to be raised by issuing securities, when added to all amounts previously raised by the body and its affiliates<sup>77</sup> by issuing securities under an OIS, is \$5m or less.<sup>78</sup>

The content requirements for an OIS are prescriptive rather than generally expressed (section 715).<sup>79</sup> The key disclosures are a recent set of audited financial statements and

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<sup>73</sup> The *CLERP Fundraising Paper* citing (at 51) Industry Commission “*Informal Equity Investment: Small Business Research Program*” Information Paper (April 1997) (that paper cites further research by Brock and Evans 1989).

<sup>74</sup> The *CLERP Fundraising Paper* noted (at 52) work of the National Investment Council “*Financing Growth: Policy to Improve the Flow of Capital to Australia’s Small and Medium Sized Enterprises*” (August 1995) at 27 - 31 and the *Wallis Committee Report* at 510.

<sup>75</sup> Reference was made (at 53) to the report of CipaNet International “*A Study on the Cost of Small Entities Obtaining and Maintaining an Official Listing on the Australian Stock Exchange*” (November 1996).

<sup>76</sup> *CLERP Fundraising Paper* Proposal No 16.

<sup>77</sup> Being related bodies corporate, entities controlled by a person who controls the issuer or an associate of such a person. An issue will arise as to when related entities or persons controlling the offeror and their associates will have prior offerings aggregated for purposes of determining the \$5m threshold. Control for these purposes is defined in section 50AA. In addition, under section 740 ASIC has an anti-avoidance power to aggregate transactions for this purpose.

<sup>78</sup> Section 709(4). An anomaly would seem to be that it is open to existing issuers, who may have raised large sums of money in the past under prospectuses and placements, to use the OIS route to raise up to \$5m. This is because it is only previous issues of securities by way of OIS that are counted for the purposes of the \$5m cap.

In determining the relevant amount of money to be raised, not only is the amount payable for securities at the time that they are issued to be included, but also amounts payable on calls in the future for partly paid securities, amounts payable on the exercise of options in the case of options and amounts payable on conversion of convertible securities: section 705(5).

<sup>79</sup> Those disclosure requirements are as follows:

- *Identification of the issuer*: The OIS must identify the body and the nature of the securities being offered.
- *Business description*: The OIS must describe the offeror’s business.

disclosure of the risks associated with an investment in the issuer. This is clearly a significantly lower disclosure standard than the general prospectus standard of disclosure.

The Explanatory Memorandum to the *CLERP Bill* stated that external inquiries are not expected to be undertaken to ascertain information about matters on which disclosure is required.<sup>80</sup> This provision interlinks with the liability regime set out in section 732 which provides that the lack of knowledge of misleading or deceptive statements or omissions is a defence to misstatement liability.

These provisions may provide a useful limitation on the inquiries required to be made and the scope of disclosure for professional advisers and others not involved in the day-to-day operation of the relevant issuer. However, in the case of directors of the issuer, the duty of care, skill and diligence requires inquiry into the affairs of the issuer and the monitoring of its business.<sup>81</sup> The practical requirements of the duty of care, skill and diligence are likely to have the result that the benefits of 'no inquiry obligation in preparing' an OIS as described in the Explanatory Memorandum to the *CLERP Bill*, are overstated for a director.

A further issue will arise as to what constitutes a lack of knowledge for these purposes. For example an issue will arise if a wilful failure to inquire when put on notice of the existence of relevant facts could constitute knowledge for these purposes.<sup>82</sup>

Serious questions can be raised as to the desirability of the OIS regime from a policy perspective. The objective of the OIS is to facilitate greater access to capital for SMEs from retail investors. It

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- *Use of funds*: The OIS must describe what the funds raised by the offers are to be used for.
  - *Risk disclosure*: The OIS must state the nature of the risks involved in investing in the securities in question.
  - *Fee disclosure*: The OIS must give details of all amounts payable in respect of the securities, including any amounts by way of fee, commission or charge.
  - *Health warnings*: The OIS must state that a copy of the statement has been lodged with ASIC and that ASIC takes no responsibility for the content of the statement. The OIS must also state that the statement is not a prospectus and, as its disclosure requirements are at a lower level than those required for a prospectus, must state that investors should obtain professional investment advice before accepting the offer.
  - *Financial statements*: The OIS must include a copy of a profit and loss statement, cash flow statement and balance sheet. Those financial statements must have a balance date that occurs within the six months before the securities are first offered under the OIS. The financial statements must also be prepared in accordance with accounting standards and must be audited. (See ASIC Policy Statement 157).
  - *Regulations*: The OIS must include other information that the regulations require to be included in the statement.

<sup>80</sup> Para 8.56

<sup>81</sup> *Daniels v Anderson* (1995) 16 ACSR 607 at 665. See also *Hone* (1998) at 320.

<sup>82</sup> See the discussion of this issue in the accessory context at text accompanying footnote 94 to 96 of Chapter 9.

does so by significantly reducing the required disclosure in an OIS as compared with a full prospectus.

To the extent that retail investors are the targets of an OIS,<sup>83</sup> one must ask if their interests are served by denying them the disclosures of a full prospectus.

SMEs are likely to be less liquid investments than larger cap stocks. SMEs (particularly in the Australian context) are likely not to have any significant analyst following and are less likely to have sophisticated institutional shareholders as investors. All this suggests, in terms of adoption of the underpinning of the efficient market hypothesis as discussed in Section 1.6, that an offering involving an SME is the least likely type of offering to give rise to efficient pricing.<sup>84</sup> In addition the lack of efficiency is likely to undermine suggestions that voluntary disclosure of material information will arise in these circumstances.<sup>85</sup>

To the extent concerns of noise theory are involved, it has been suggested above that specific disclosure obligations should be considered by the regulator from time to time to deal with these concerns. While there is a regulation power in the OIS provisions, there has been no suggestion to date that it should be used.

It can therefore be expected that in many instances the risks associated with smaller enterprises are greater than for larger enterprises.<sup>86</sup> As noted above, the higher risks were acknowledged as such in the *CLERP Fundraising Paper*. It will be noted that “the nature of risks” must be disclosed in the OIS. To the extent that this requirement is strictly enforced many of the concerns with the OIS may dissipate. However, to the extent that the disclosure requirement is dealt with by issuers in a cursory way, these concerns will continue.

It is clear that there is a high fixed cost element to fundraising which results in disproportionately higher costs to smaller issuers than larger issuers. That is not an issue unique to Australia.

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<sup>83</sup> On the basis that it is always open to an institutional investor to invest in an SME having regard to the exemptions from prospectus lodgment open to an institutional investor. One does not need to be a devotee of the information economists to consider that an institutional investor could bargain for disclosure of the matters set out in the CL s.710 disclosure standard.

<sup>84</sup> See also *Grose (1998)* at 308 - 9.

<sup>85</sup> See the analysis in *Rousseau (2000)* at 709 - 715.

<sup>86</sup> By way of illustration of this fairly self evident proposition see the experience of failure to achieve financial forecast performance of small-cap floats as compared to large-cap floats set out in Section 6.3 below. It would be logical to assume SME's would perform even more poorly by such comparisons.

The question is whether investor protection should be sacrificed for lower costs of capital raising at this end of the market. Having regard to the possibility that small investors do not closely read offering documents, that market prices for these types of offerings are not efficient and the risks involved, a good case be made that the OIS proposals are very poorly based in policy. Indeed, having regard to the cycle of boom and bust that have driven increasing regulation of retail offering documents, it can be fairly safely predicted that there will be a future pressure to revisit the OIS regime.<sup>87</sup>

For these reasons the OIS regime has met with a fairly sceptical reaction.<sup>88</sup> On the whole, the OIS reforms smack of political opportunism rather than proposals with a well developed theoretical policy basis.

Possible better ways of providing lower cost funding to SMEs would be to provide greater encouragement for investment by institutions (for example through tax concessions) and to encourage the development of the venture capital market in Australia.<sup>89</sup>

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<sup>87</sup> The need to deal with the requirements of SME's has been recognised in many jurisdictions during the 1990s. It is Australia's solution that would seem the most extreme solution proposed.

In the United Kingdom, since 1995 entities that do not meet the profit history requirements of the London Stock Exchange may list on the Alternative Investment market (AIM) which has (compared to a listing for a normal entity seeking listing) reduced disclosure requirements under the Rules of the UK Listing Authority (Chapter 16). For a description see *Gleeson & Bloomenthal (1999)* at 398 - 402.

In 1999 in Canada a junior stock market was created for SMEs with proposals for special disclosure rules for SMEs made in 1995 - Ontario Securities Commission Task Force on Small Business Financing "*Proposal For Comment*" (Toronto 1995). For a description see *Rousseau (2000)* at 717 - 759. The Canadian proposals focussed on the desirability of mandating disclosure of forward looking information over historical information (particularly business plans and proposed uses of funding). This would seem much more relevant than the limited historical information contemplated by an OIS. In relation to liability, underwriter liability was proposed to be removed to reduce the cost of underwriting and broking (for criticism see *Rousseau (2000)* at 744 - 748) and safe harbours for certain omissions

<sup>88</sup> See *Black, Bostock, Golding & Healey (2000)* at paragraph 2.59 (this author's views); *Hone (1998)* at 320-1.

The reaction of the Australian Stock Exchange in relation to the introduction of the OIS regime was to deny listing based on such a disclosure statement: see *Exposure Draft — Proposed Listing Rule Amendments 1 September 1999, ASX*, paras 1.4– 1.9.

The use of the stop order power by ASIC since the introduction of the OIS regime illustrates the concerns expressed above. Many of the capital raisings where ASIC has issued stop orders are where the OIS regime is being used (see the examples referred to in ASIC press release 01/112 and 01/052).

<sup>89</sup> Venture capitalists are said to play an important role in reducing the information asymmetry between corporate insiders and investors on whose part venture capitalists invest (through detailed research before investing, board representation and staged investment strategies) and acting as reputational intermediaries and gatekeepers when the SME ultimately goes public - for discussion see *Rousseau (2000)* at 694 - 699.

## Profile Statements

The final disclosure document is the profile statement, again introduced by the *CLERP Act*. The *CLERP Act* contemplates that profile statements will be primarily contemplated for retail offerings where standardised investment products are involved.

Proposal for profile statements had come from the recommendations of the *Wallis Committee*. The *Wallis Committee* recommended that profile statements be required for all prospectuses and that investors be permitted to make their investment decision on the basis of those statements.<sup>90</sup>

These proposals were based primarily on the New Zealand approach where investment statements are required for all offers of securities.<sup>91</sup> The investment statement is intended for use by non-expert investors setting out answers to 11 key questions considered important in making an investment decision. The application form is part of this statement, allowing investments to be based solely on the investment statement.

This approach is different to the development of profile statements in other jurisdictions where initiatives are being considered only for the development for such statements in the mutual fund area.<sup>92</sup>

However, the *CLERP Fundraising Paper* noted that while some products may benefit from individually tailored profile statements sanctioned by the regulator, if the law were to mandate profile statements it would impose additional costs on issuers as issuers would need both to ensure both the profile statement and the prospectus made the correct disclosure for these documents.<sup>93</sup> For this reason the *CLERP Fundraising Paper* recommended that ASIC be given

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<sup>90</sup> *Wallis Committee Report* at 267. It was proposed that the mandatory disclosure requirement for a profile statement would provide uniform information on key aspects of the investment, including an outline of the nature of the investment, standard charges for purchasing and selling the securities, relevant risks and other disclosures for specific products considered appropriate by the regulator. *Wallis Committee Report* Recommendation 9 at 266 - 8.

<sup>91</sup> Section 38D of the *Securities Act (New Zealand)*. The approach is now also copied in Singapore (section 45A of the *Companies Act (CAP 50)*).

<sup>92</sup> In the United States the SEC is undertaking a project for the development of profile statements for mutual funds offerings. A full prospectus would need to be delivered at the time confirmation of a successful application is made.

The Ontario Securities Commission is also undertaking a project to develop profile statements for mutual fund offerings. For a summary see *CLERP Fundraising Paper* at 18 - 9

<sup>93</sup> *CLERP Fundraising Paper* at 20 - 1.

the power to sanction the use of profile statements in suitable industries but that profile statements not be mandatory for all offerings.<sup>94</sup>

At a policy level the profile statement proposal represents something of a lost opportunity. A lesson from the theoretical policy perspective in Section 1.6 is that the intermediation of the investment process and the development of understanding as to the operation of information flows impacts on securities markets suggests that there is a place for a debate as to the way in which information is made available to retail investors.

It may be that the dissemination of abbreviated disclosure documents to retail investors can be justified in terms of the information needs of those types of investors. Such an approach should not be seen to undermine the information disclosed to the overall market because the dissemination of a profile statement does not negate the need to prepare a prospectus meeting the general disclosure standard. The comments made above as to information efficiency apply equally to this area.<sup>95</sup>

Since the enactment of the *CLERP Act* some of this objectives can be achieved through the incorporation by reference provisions of *CA* section 712. The difficulty with that section is that disclosure must be made providing a description of the information that may be of interest to retail investors.<sup>96</sup> It will be difficult to identify what that information may be. A profile statement of specified summary information (with clear identification of the accessibility of more detailed information) may have been a better way to approach this issue from the policy perspective.

Profile statements give rise to similar liability considerations to an offer information statement. However, it should be remembered that a profile statement does not negate the need for an issuer to prepare and lodge a formal prospectus in relation to the offering. In connection with such an offering, the *Corporations Act* provides that a person who acquires securities as a result of the offer accompanied by a profile statement is taken to have acquired the securities in reliance on both the profile statement and the prospectus for the offer.<sup>97</sup> As such, in the unique situation of a

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<sup>94</sup> *CLERP Fundraising Paper* Proposal No 3. The *CLERP Fundraising Paper* noted in this regard the work of ASIC and the Investment Funds Association of develop a short form disclosure document for use by the managed investments industry.

<sup>95</sup> See text at footnotes 50 to 53.

<sup>96</sup> See text at footnote 29.

<sup>97</sup> Section 729(2) of the *Corporations Act*.

profile statement reliance is explicitly not required. For the reasons advanced in Chapter 3, the removal of a reliance requirement is desirable from the policy perspective.

### 6.3 A CASE STUDY ON THE INTERACTION OF DISCLOSURE AND LIABILITY RULES - THE DISCLOSURE OF PROSPECTS

#### Background Relevance

One of the most controversial aspects of the prospectus disclosure standard imposed by the *Corporations Law* was the requirement for disclosure of “prospects”. In the popular mind, the requirement for disclosure of prospects very quickly equated with the necessity for the inclusion of a financial forecast in the disclosure document.

A discussion of prospects, or the inclusion of financial forecasts in a prospectus, is merely one part of a category of disclosure that can be considered “soft information”, being statements of intention, prediction or opinion concerning likely future events that are a feature of prospectus disclosures.<sup>98</sup> Soft information is inherently ambiguous. On the other hand, it is the very information that investors are likely to find the most helpful in forming an assessment of the value of a security because forward looking information is likely to be more relevant to assessing likely investment returns than historical information as it represents management’s expectations or plans for the future.

Historically the Australian companies legislation had actively discouraged the inclusion of forward looking information in some contexts, presumably reflecting a paternalistic concern that investors may place inappropriate reliance on such information.<sup>99</sup> Since the enactment of the *Corporations Law*, the inclusion of a financial forecast in an Australian disclosure document has

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<sup>98</sup> In *Schneider (1972)* the following categories of soft information were identified as relevant in the securities context (at 254 - 7):

- forward looking statements about the future such as forecasts, projections and statements of plans.
- statements of opinion about past events that are not verifiable (eg a statement of market share that cannot be verified).
- subjective opinions about factual matters (eg a statement that management is “competent”).
- statements of motive, purpose and intention.
- descriptive statements (eg that a company has “excellent” assets).

<sup>99</sup> See for example section 37 of the *Companies (Acquisition of Shares) Act 1981* that prohibited a bidder or target from publicly releasing a profit forecast during an offer period (unless approved by the regulator).

become the norm. For example, in the period July-December 1995, ASIC reported that 55% of prospectuses offering equity in new ventures contained some type of financial forecast.<sup>100</sup>

However, the inclusion of this information has been controversial because of the inherent unreliability of prospective financial information such as forecasts. The outcome of actual financial performance in a period the subject of a forecast will be dependent upon numerous factors, many of which will be outside the control of the person preparing the forecast (for example general economic conditions). The Australian experience with the inclusion of financial forecasts in prospectuses has demonstrated the limitations of the reliability of that type of information.

Useful data on the Australian record in relation to financial forecasting has been accumulated over the last decade by PricewaterhouseCoopers. That data shows a significant underperformance by companies seeking new listings on ASX in achieving disclosed forecast results. Using a threshold failure to achieve a financial forecast in the first year forecast (likely to be the most reliable forecast period) by more than a 15% margin of error, the experience reported by PricewaterhouseCoopers can be summarised as follows:<sup>101</sup>

<b>Calendar Year</b>	<b>Large Cap Companies approx % failure</b>	<b>Small Cap Companies approx % failure</b>
2000 (incomplete survey)	22%	27%
1999	25%	60%
1998	48%	38%
1997	52%	42%
1996	12%	32%
1995	25%	58%
1994	8%	34%
1993	0%	28%
1992	0%	32%

<sup>100</sup> ASC Issues Paper "Inclusion of Financial Forecasts in Prospectus" (October 1996) at paragraph 6.3.

For IPO's to be listed on ASX the likely percentage is much higher. For example, in the PricewaterhouseCoopers "Survey of Sharemarket Floats 2000" (PricewaterhouseCoopers © 2001) it was reported that for 2000 90.6% of large cap IPO's included financial forecasts of at least 1 year, while for small cap floats (market capitalisation of less than A\$100 million on listing) the figure was 70.3%.

<sup>101</sup> PricewaterhouseCoopers "Survey of Sharemarket Floats 2000" (PricewaterhouseCoopers © 2001) at 14. For the above tables a large cap company is one having a market capitalisation exceeding A\$100 million at the time of listing. It should be noted that in a number of these years there were few large cap company offerings (thereby distorting the resulting percentages).

While the results show significant volatility from year to year, the level of underachievement is alarming if it were to be assumed that investors make investment decisions based on a perception of the reliability of this type of information. In many of the years, more than one third of companies underperformed and in 2 years for each of the tracked large cap and small cap listings the underperformance was experienced by 50% or more of companies.<sup>102</sup>

While ASIC has indicated on various occasions that it will review the circumstances surrounding the non-fulfillment of a financial forecast in a disclosure document lodged under the *Corporations Act*,<sup>103</sup> no enforcement proceedings have been commenced by ASIC in relation to those circumstances, despite the performance record outlined above.

Against this background there have been calls to re-evaluate the suggestion that a disclosure document should contain a financial forecast. The *CLERP Fundraising Paper* concluded:

“Whether a forecast is required should be left for determination under the general prospectus content rule, namely be reference to whether the forecast would be reasonably required. Meaningful forecasts should be encouraged because of their usefulness to potential investors.”<sup>104</sup>

In assessing the legal requirements relevant to the need to incorporate a financial forecast in a prospectus it is necessary to consider the interplay of the disclosure standard with the applicable liability regime because the liability treatment adopted by the courts involves important subtleties of analysis.

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<sup>102</sup> In Australia these conclusions are supported by the earlier, more limited survey of P. Lee, S. Taylor, C. Yee & M. Yee “*Prospectus Earnings Forecasts: Evidence & Explanations*” (1993) May, Aust Accounting Rev 21. The results suggest “not only that IPO earnings forecasts provided in prospectuses are inaccurate, but also that they tend markedly towards the optimistic” (at 22). The statistically significant differences in forecast errors were said to be the size of the offering (small versus large issuers) and the period of the forecast (at 29).

In *Mak (1994)* it is suggested that the existence of an operating history is a proxy for the availability and verifiability of forecast information (based on a review of IPO prospectus in New Zealand) (at 141).

<sup>103</sup> Most recently in Media Release IR 01/05 “*ASIC provides guidance for preparers and reviewers of prospective financial information included in disclosure documents*” (7 February 2001) (ASIC indicating it will no longer accept forecasts based on hypothetical assumptions as those terms are defined in Australian Auditing Standard AUS 306) and draft Policy Statement 170 discussed at text accompanying footnotes 175 to 177 below.

<sup>104</sup> *CLERP Fundraising Paper* at 27. The *Loneragan Committee Report* similarly did not support the mandatory inclusion of forecasts in prospectuses.

### Historic Approach to Soft Information

Statements of intention, prediction or opinion have traditionally been given special treatment by the courts where allegations of misstatement liability are made. The traditional approach under the tort of deceit is the proposition that a misrepresentation must involve a statement of fact, and that statements of intention, prediction or opinion do not constitute a statement of fact and are therefore immaterial as a matter of law.<sup>105</sup>

The point is well illustrated in the prospectus context by the early case of *Bellairs v Tucker*<sup>106</sup> where a prospectus statement that the directors “confidently believe the profits of this company will be more than sufficient to pay dividends of at least 50 percent of the nominal capital” were rejected as forming the basis of a proper deceit action because the statement was considered to constitute words of mere hope and opinion and was therefore immaterial.<sup>107</sup>

On the other hand implicit in any statement of intention, prediction or opinion is a statement of fact - at the very least that the maker of the statement holds the belief at the time it is made, even if the intention later changes. If that belief was not in fact held an actionable misstatement will arise.<sup>108</sup> However, establishing that the belief was not held will involve difficult factual issues relating to the state of mind of the maker of the statement:

“There must be a misstatement of an existing fact but the state of a man’s mind is as much a fact as the state of his digestion. It is true that it is very difficult to prove what the state of a man’s mind is at a particular time is, but if it can be ascertained it is as much a

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<sup>105</sup> For early authority see *Jorden v Money* (1854) 10 ER 868; *Bellairs v Tucker & Ors* (1884) 13 QBD 562; *Bentley & Co v Black* (1893) 9 TLR 580. In the Australian prospectus context see *The Civil Service Co-operative Society of Victoria Limited v Blyth & Ors* (1913) 17 CLR 601 at 609 (Barton J). In Canada see *Pioneer Tractor Co Ltd v Peebles* (1914) 18 CLR 477.

<sup>106</sup> *Ibid*

<sup>107</sup> *Ibid* at 573 (Denman J).

See also *Bentley v Black* (1893) 9 TLR 580 - “anticipation of future results is not a statement of fact” (Lord Esher MR).

<sup>108</sup> See for example *Edgington v Fitzmaurice* (1885) 29 Ch D 459 (statement as to intended use of proceeds of prospectus issue when directors intended another use); *Re New Brighton Recreation Ground Co Ltd* (1889) 10 NSW (Eq) 66 (prospectus representations could not be implemented at time statement of intention made).

Further examples arise in circumstances where a statement of intention is expressed as a statement that a situation in fact existed - see for example *Hallows v Fernie* (1868) 3 Ch App 467 (prospectus statement that company would start operations with assets not owned at the time); *Collins v Associated Greyhound Racecourses, Ltd* [1930] 1 Ch 1 (prospectus disclosed assets being acquired - acquisition did not proceed); *In Re Metropolitan Coal Consumers Association (Karberg’s Case)* [1892] 3 Ch 1 (prospectus statement that persons would join the board of directors when no consent to act had been given); *Aaron Reefs, Limited v Twiss* [1896] AC 273 (prospectus statement as to state of assets - at 284).

For an example in the modern prospectus context see the facts of *Flavel v Giorgio* (1989) 15 ACLR 486 (successful prosecution that director did not have the intention stated in the prospectus).

fact as anything else. A misrepresentation as to the state of a man's mind is, therefore, a misstatement of fact."<sup>109</sup>

Once a statement of intention is made, liability may arise if there is a failure to correct the statement where the maker of the statement should have realised the statement has ceased to be true.<sup>110</sup>

### Section 52/Section 1041H Jurisprudence

The recent Australian law in relation to the *Misleading and Deceptive Conduct Provisions* as it applies to statements of intention, prediction or opinion has generally developed by reference to the principles outlined above.<sup>111</sup> There is a relatively large body of case law applying to a variety of factual contexts.

At a very early point in the development of the section 52 case law it was established that an unkept promise or a statement of intention in relation to the future which is not honoured or a forecast that is not met does not, of itself, constitute misleading or deceptive conduct:<sup>112</sup>

“a prediction or statement as to the future is not false within the words of that section if it proves to be incorrect”.<sup>113</sup>

However, it was quickly established that, consistent with the common law analysis above:

“A statement which involves the state of mind of the maker ordinarily conveys the meaning (expressly or by implication) that the maker of the statement had a particular state of mind when the statement was made and, commonly at least, that there was a basis for the state of mind.”<sup>114</sup>

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<sup>109</sup> Bowen CJ in *Edgington v Fitzmaurice* (1885) 29 Ch D 459 at 483.

<sup>110</sup> *Abrams (J & JC) Limited v Ancliffe* [1978] 2 NZLR 420 (a negligence case).

<sup>111</sup> For a useful summary see *French (1989)* at 259-61.

It has been argued by Greig & Davis in *“The Law of Contract”* (Law Book Company, 1987) at 813 that section 52 departs from the general law and imposes liability irrespective of whether a statement of present fact exists and irrespective of the state of mind of the maker of the statement. However, the case law cited below does not generally support that proposition. For analysis see CD Steytler *“Misleading or Deceptive Conduct by Representations as to Future Matters or Conduct”* at 32-38 and R S French *“The Action for Misleading or Deceptive Conduct: Future Directions”* at 292-3, each in C Lockhart (Ed) *“Misleading or Deceptive Conduct: Issues and Trends”* 1996, Federation Press.

<sup>112</sup> The leading authorities for this general proposition can be traced through *Thompson v Mastertouch TV Services Pty Ltd* (1977) 15 ALR 487 (FCA, Franki J) (basing its analysis on the House of Lords in *British Airways Board v Taylor* [1976] 1 All ER 65, a decision relating to the UK *Trade Descriptions Act* which is very much consistent with the traditional analysis referred to above); *Bill Acceptance Corporation Ltd v GWA Ltd* (1983) 50 ALR 242 (FCA, Lockhart J); *Global Sportsman Pty Ltd & Anor v Mirror Newspapers Ltd & Anor* (1984) 55 ALR 25 (FCA, Bowen CJ, Lockhart & Fitzgerald JJ); *James & Ors v Australia and New Zealand Banking Group Ltd & Ors* (1985) 64 ALR 347 (FCA, Toohey J).

<sup>113</sup> *Thompson v Mastertouch TV* Ibid at 495. See also *Global Sportsman* Ibid at 31 for early authority.

The Australian case law demonstrates a number of illustrations of that general principle that provide useful lessons in the securities law context.

The first example is where statements are made by a person as to their intentions in the future. In these circumstances it is suggested that the statement may contain an implied statement:

“That the promisor has a present intention to make good the promise and it may represent impliedly that he has the means to do so”.<sup>115</sup>

If that implied promise exists and the statement is not honoured, misleading and deceptive conduct will arise.

There is a large body of cases that demonstrates this general proposition.<sup>116</sup>

The next category of case relates to the basis of belief in the accuracy of the of opinion or prediction. The general approach of the Australian Courts has been to find liability if it can be shown that the maker of the statement did not honestly hold the belief expressed. There is some looseness in the analysis as to the standard of conduct that will be imposed in these circumstances - the cases referring alternatively to that of fraud (actual knowledge or recklessness) or the lower threshold of negligence. In *Thompson v Mastertouch TV Services Pty Limited*<sup>117</sup> it was suggested liability will arise if the maker of the statement “did not believe that the forecast or prediction would be satisfied or was recklessly indifferent concerning the forecast or prediction”.<sup>118</sup> In other words, a standard of deceit in relation to the making of the prediction.

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<sup>114</sup> *Global Sportsman v Mirror Newspaper* supra. See also *James v ANZ* supra (containing a useful summary of the relevant law.) The genesis of this proposition from the quote from *Edgington v Fitzmaurice* extracted above is clear, even though the general law principle was not referred to in the *Global Sportsman* case.

<sup>115</sup> *James v ANZ* supra citing *Thompson v Mastertouch TV Services*.

It has been argued that the making of the promise and its subsequent breach in aggregate constitutes misleading or deceptive conduct irrespective of intention - see *Greg & Davis* supra and the discussion in *Steitler* supra relying on cases such as *Holt v Biroka Pty Ltd* (1988) 13 NSWLR 629 (Kearney J). However, that argument appears suspect.

<sup>116</sup> See *Brown v Jam Factory Pty Ltd* (1981) 35 ALR 79 (Fox J) (lease of premises representation that surrounding premises would be let); *Mister Figgins Pty Ltd v Centrepoint Freeholds Pty Ltd* (1981) 36 ALR 23 (Northrop J) (similar); *Cohen v Centrepoint Freeholds Pty Ltd* (1982) 66 FLR 57 (similar); *Lyons v Kern Konstructions (Townsville) Pty Ltd* (1983) 47 ALR 114 (similar); *TN Lucas Pty Ltd v Centrepoint Freeholds Pty Ltd* (1984) 1 FCR 110 (Jenkinson J) (similar); *RG Steedman & Ors v Golden Fleece Petroleum Limited* (1986) ATPR 40-660 (Woodward J) (promise to undertake work on premises in future); *Kennard & Anor v AGC (Advances) Ltd & Ors* (1986) ATPR 40-747 (Pincus J); *Wright v TNT Management Pty Limited* (1989) 15 NSWLR 678 (Mahoney, Clarke, McHugh JJ) (implied representation to maintain safe work practices); *Futuretronics International Pty Ltd v Gadzhis* [1992] 2 VR 209 (Ormiston J); *Poseidon Limited & Anor v Adelaide Petroleum NL & Ors* (1992) ATPR 41 - 164 (FCA, Sheppard J, Burchett J & Lee J). For a United Kingdom antecedent see *R v Sunair Holidays Ltd* [1973] 2 All ER 1233 at 1236.

For earlier consistent case law see *Jones v Dumbrell* (1967) [1981] VR 199.

<sup>117</sup> Involving a statement made in the sale of a business that a person “should earn \$400 a week minimum”. The case involved a criminal prosecution under section 59 of the Trade Practices Act.

On the other hand, a distinction would seem to have been drawn in circumstances where an opinion is expressed by a person who has expertise in relation to a particular matter. In these circumstances a negligence standard has been suggested. The case of *Bateman v Slatyer*<sup>119</sup> involved allegations of misleading and deceptive conduct in relation to the sale of a franchise business by directors of the franchisor.<sup>120</sup>

“Such an opinion may convey that there is a basis for it, that it is honestly held, and when it is expressed as the opinion of an expert, that it is honestly held upon rational grounds involving an application of the relevant expertise....I think no serious attempt at all was made to establish a basis for the figures contained in the first cashflow projection or indeed the second and the directors of the company who had had considerable experience in enterprises of this kind,....could not have believed that the figures were soundly based.”<sup>121</sup>

It is significant that the expected status of the directors in the case was considered to flow from their “considerable experience in enterprises of this kind”. That is a very broad interpretation of what will constitute expert qualifications as a basis for distinguishing a fraudulent standard of conduct from a negligence standard.

It may be that, although not expressed in these cases, the distinction will turn on whether a duty of care exists at general law. Certainly, in the cases that have imposed a negligence standard, the relationship of the parties may have been sufficient to establish a duty of care.

It would seem that from the policy perspective, at least in the securities law context, a lower standard of conduct to fraud is appropriate. The investing community can expect that statements

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<sup>118</sup> *Thompson v Mastertouch TV* at 495. To similar effect, see *Stack v Coast Securities No 9 Pty Ltd* (1983) ATPR 40-342 (Fitzgerald J) at 44,119, *Bill Acceptance Corporation Ltd v GWA Ltd* at 44,761. For a case where liability was not established see *Tomlinex Pty Ltd v Candoura Pty Ltd & Ors* (1994) ATPR 41-302 (FCA, O’Loughlin J) (opinion as to when regulatory body would grant mining lease did not result in liability).

For securities law cases where the expression of opinion did not result in liability see *Industrial Equity Ltd v North Broken Hill Holdings Limited* (1986) 64 ALR 293 (Burchett J) (newspaper advertisements in takeover) and *Bell Resources Ltd & Anor v The Broken Hill Proprietary Company Limited & Ors* (1986) ATPR 40-702 (Smithers J) (profit forecast in takeover documents).

<sup>119</sup> *Bateman & Anor v Slatyer & Ors* (1987) 71 ALR 553 (FCA, Burchett J).

<sup>120</sup> The representations related to projected cash flows, representations that there was no risk of loss on the investment, representations that the investment would be repaid within a year and representations as to the appropriateness of the premises for the business (at 558).

<sup>121</sup> *Ibid* at 559. Support for this proposition was said to be based on *James v Australia and New Zealand Banking Group Limited* supra and *Geale v Glenhoun Holdings Pty Ltd* (1985) 7 ATPR 46,970 at 46,978-9. The statement has received support in *Tomlinex Pty Ltd v Candoura Pty Ltd & Ors* (1994) ATPR 41-302 (O’Loughlin J). See also *Chiarabaglio & Anor v Westpac Banking Corporation* (1989) ATPR 40-971 (FCA, Foster J) (statement by bank officer as to benefits of foreign currency loan involved “no reasonable basis for that opinion” at 50,630).

of future performance and opinion should not be lightly made and that the maker should have a reasonable basis as to their making.<sup>122</sup>

A further theme from the case law that is of significance in the securities law context is the proposition is that where a forecast of future performance is made, the material assumptions upon which it is made need to be set out in order for misleading and deceptive conduct to be avoided. In *Wheeler Grace & Pierucci Pty Ltd v Wright*,<sup>123</sup> a projection was made as to the expected rate of return that could be achieved on an investment in a security. Liability was established in relation to the statement because, among other things, of a failure to set out the risks of non-fulfillment:

“A positive unqualified prediction by a corporation may be misleading conduct in trade or commerce if relevant circumstances show the need for some qualification to be attached to that statement or the possibility of its non-fulfillment to be disclosed as a requirement of fair trading. The fact that the corporation believed or had reasonable grounds for belief that the prediction would be fulfilled, would not answer the question as to whether the conduct was misleading or deceptive conduct in trade or commerce. Misleading or deceptive conduct may be found in the failure to qualify the statement or disclose the risk of non-fulfillment in the event of non-fulfillment of a prediction or promise may be evidence that raises an inference of such a risk or non-performance existed on the qualification of the positive statement prediction or promise was required. Each case will depend upon its own circumstances.”<sup>124</sup>

In the securities law area, it seems correct as a general matter of policy that the complexity of financial forecasts can only be properly appreciated by reference to disclosure of the significant assumptions and qualifications upon which they are based. That proposition also flows strongly out of the ASIC Practice Note on financial forecasts.<sup>125</sup>

The application of the principles that a failure adequately to disclose assumptions underlying projections can be misleading is illustrated in the prospectus context by the decision of *Famel v Burswood Management Limited*<sup>126</sup> and *Morey v Transurban City Link Ltd*.<sup>127</sup> The principle is

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<sup>122</sup> This general analysis is affected by section 51A of the *Trade Practices Act* (inserted in 1986), discussed below.

<sup>123</sup> *Wheeler Grace & Pierucci Pty Ltd v Wright & Anor* (1989) ATPR 90-490 (Full Federal Court, Neaves, Burchett & Lee JJ).

<sup>124</sup> *Ibid* at 50,251 (Lee J).

<sup>125</sup> Practice Note 67 at 67.2, 67.19, 67.24. See also draft Policy Statement 170. For further discussion see the analysis below.

<sup>126</sup> *Famel Pty Limited & Anor v Burswood Management Limited & Ors* (1989) ATPR 40 - 962 (FCA, French J). The prospectus in question contained an estimate of the construction costs for a casino and an expert report confirming the achievability of that estimate. A strike out application failed because the judge considered that the expert report might be misleading if a higher estimate had predated the expert report or the estimate did not include the construction of all of the casino.

<sup>127</sup> *Morey v Transurban City Link Ltd* (1996) 20 ACSR 388 (Northrop J). The application for an injunction based on section 52 failed.

also well illustrated in recent years by a number of takeovers cases relating to the disclosure of forecasts where inadequate disclosure of assumptions was established. The leading cases are *Primac Holdings Ltd*<sup>128</sup> and *GIO v AMP*.<sup>129</sup>

### Section 51A/Section 765

Through a modification to the traditional liability rules for soft information, the *Trade Practices Act* and *Corporations Law* imposed a significant psychological impediment to the voluntary disclosure of soft information. Section 51A of the *Trade Practices Act* and section 12BB of the *ASIC Act* reverses the onus of proof in relation to soft information so that when a person makes a:

“representation with respect to any future matter (including the doing of, or the refusing to do, any act) and the person does not have reasonable grounds for making the representation, the representation shall be taken to be misleading”.

In addition, under these provisions the person bears the evidentiary burden:

“unless the person adduces evidence to the contrary, be deemed not to have had reasonable grounds for making the representation”.

Section 51A was inserted into the *Trade Practices Act* in 1986.<sup>130</sup>

The *Trade Practices Act* jurisprudence make it clear that even without section 51A, as outlined above, the disclosure of soft information may still result in misleading and deceptive conduct.<sup>131</sup>

Oddly, section 1041H does not incorporate this deeming provision. This would seem to have been a drafting deficiency in the introduction of the *Financial Services Reform Act 2001*, with the

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<sup>128</sup> *In the Matter of the Corporations Law and In the Matter of Primac Holdings Ltd* (1996) 22 ACSR 212 (SC Qld, Dowsett J) and *Primac Holdings Ltd v IAMA Ltd & Ors* (1996) 22 ACSR 454 (SC Qld, Dowsett J). The *Wheeler Grace & Pierucci* case was not referred to by Dowsett J.

<sup>129</sup> *GIO Australia Holdings Ltd v AMP Insurance Investment Holdings Pty Ltd 2 Anor* (1998) 29 ACSR 584 (FCA, Emmett J).

A comparison of the *Primac* and *GIO* cases suggests that the *GIO* case would not require the disclosure of assumptions underlying a projection to the same degree as the *Primac* case. See also *Emlen Pty Ltd v St Barbara Mines Ltd* (1997) 24 ACSR 303 (SC of WA, Wheeler J) (no interlocutory injunction given to relation to argument that assumptions underlying a statement of prospective “strong” cashflows should be disclosed).

<sup>130</sup> Inserted by Act No. 17 of 1986.

The express purpose of section 51A was to reverse the judicial view in *Thompson v Mastertouch* supra that liability for representations as to the future required a showing of dishonesty or recklessness on the part of the person making the representation where the circumstances surrounding such matters are within the knowledge of the person making the representation. See Explanatory Memorandum to *Trade Practices Amendment Bill 1985* at 19.

<sup>131</sup> In addition the relevant legislation provides that this requirement shall not be taken to limit the application of the primary prohibition on misleading and deceptive conduct - see for example section 12BB(3) of the *ASIC Act*.

result that the previous *Trade Practice Act* case law applies to the interpretation of section 1041H.

There is little case law that focuses specifically on section 51A and its impact upon the scope of the liability regime. Clearly, the major impact is an evidentiary one.<sup>132</sup>

One distinction may be in the area of making statements as to future intended conduct. As noted above, the general law suggests there will be no liability if that intention is not fulfilled unless there is a present intention to make good the conduct. Section 51A suggests that if a statement of intended conduct is made on unqualified terms without any reasonable grounds for so expressing it, section 51A will more clearly impose liability.<sup>133</sup> The case law described above between the possible distinction between a fraud and negligence standard as to the appropriate basis of belief in relation to a projection is relevant. Section 51A opts for a negligence standard in all circumstances.

In *GIO v AMP Insurance*<sup>134</sup> a distinction was drawn for purposes of section 51A (and the related statutory provisions) between representations concerning a future matter and representations as to the state of mind of a person making statements of opinion. In this context Emmett J considered that a statement of belief did not constitute a statement as to a future matter for purposes of section 51A but instead reflected a simple statement of fact, being the current state of mind of the relevant person.<sup>135</sup> This would appear to be a very narrow interpretation of the scope of section 51A.

Prior to the enactment of the *CLERP Act*, section 765 of the *Corporations Law* adopted the same language as section 51A for purposes of prospective financial information contained in prospectuses. However, the *CLERP Act* has now removed the reverse onus of proof for disclosure documents lodged under Chapter 6D.

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<sup>132</sup> See *Sykes v Reserve Bank of Australia* (1999) ATPR 41-669 (FCA, Heerey J); *Cummings v Lewis* (1993) 113 ALR 285 at 295 (FCA, French J, Shepherd & Neaves JJ); *Ting v Blanche* (1993) 118 ALR 543 at 552 (FCA, Hill J); *Futuretronics International Pty Ltd v Gadzhis* [1992] 2 VR 217 (Ormiston J) at 234-241. See also R S French "The Law of Torts and Part V of the Trade Practices Act" (Chapter 8 in Finn (ed) "Essays in Tort") at 189 - 90.

<sup>133</sup> See Steytler supra note 110 at 38 and McHugh JA in *Wright v TNT Management Pty Ltd* supra at 688.

<sup>134</sup> *GIO Australia Holdings Ltd v AMP Insurance Investment Holdings Pty Ltd & Anor* (1998) 29 ACSR 582 (FCA, Emmett J).

<sup>135</sup> *Ibid* at 616-7. The relevant statement was the belief of the board of the parent company of the offeror as to the financial results of the parent in the prospectus forecast period.

The reason given for this is that meaningful forecasts should be encouraged in the prospectus context because of their usefulness to potential investors.<sup>136</sup> It was considered that the reverse onus of proof discouraged the inclusion of material of potential use to investors because issuers perceive that its operation exposes them to liability for legitimate forecasting. As such, it was felt that the reverse onus of proof had acted as a deterrent to the inclusion of forecasts.<sup>137</sup>

The *CLERP Bill* therefore provided that the reversal of the onus of proof in section 51A/section 765 be removed in the prospectus context.<sup>138</sup>

As such, CA section 728(2) now provides that a person is taken to make a misleading statement about a future matter if they do not have reasonable grounds for making the statement. The change in the onus of proof is desirable. However, as noted by the analysis above, this can be considered as largely descriptive of the Australian jurisprudence on the issue.<sup>139</sup> The change is therefore ultimately peripheral to the main issues under consideration in relation to the obligation to disclose prospects.

### Australian Case Law on “Prospects”

Against the above background, the recent case law on soft information in securities transactions can be assessed.<sup>140</sup> Over recent years this issue has been raised before a number of Australian

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<sup>136</sup> *CLERP Fundraising Paper* at 27-8 and Proposal No. 5.

<sup>137</sup> It should be noted that no evidence was presented to support this proposition, anecdotal or otherwise. Similarly the high rate of inclusion of financial forecasts in Australian prospectuses as compared with disclosure documents in other jurisdictions (see below) does not support that conclusion. The foregoing is not to suggest that the prior regime was appropriate from a policy perspective.

Similarly, in 1992 the Lonergan Committee had recommended this change for the same reasons - see *Lonergan Committee Report* at paragraph 31 and 120 - 129 (at that time ASIC rejected those arguments - see “*First Part of ASC Comments Regarding Recommendations of Lonergan Committee*” (ASC, May 1992) at paragraph 8.33 - 8.36).

<sup>138</sup> It was said that this:

“will encourage the inclusion of material of potential use to investors without exposing issuers to liability for legitimate forecasting. The provision also ensures that forecasts are made where there is a reasonable basis for them and not made on the basis of genuine but unreasonable beliefs of issuers”. (Paragraph 8.13 of Explanatory Memorandum to CLERP Bill.)

<sup>139</sup> Also argued by *Croker* (1998) at 77.

<sup>140</sup> For discussion of the case law see Case Note (D.C. Price) “*Takeovers and the Disclosure of Information*” (1995) 69 ALJ 596; Case Note (D. Nathanson) “*A Modest Judgment on What Should and Should Not Be in Takeover Documents? Or a New Disclosure Standard for Scrip Takeover and New Issue Prospectuses?*” (1995) 18 UNSWLJ 523; R Gerrard “*Pancontinental Mining Ltd v Goldfields Ltd: The Content of Part A Statements*” (1995) AMPLA Yearbook 564; Case Note (A Walker & N Butler) (1995) 13 C&SLJ 389; Note (S Walker & R Kriedemann) “*Forecasts: Misleading or Essential*” (1997) 15 C&SLJ 47; J.Kyrwood “*Disclosure of Forecasts in Prospectuses*” (1998) 16 C&SLJ 350 and S. Hirst, L. Law & G. Gallery “*When Will a Forecast be Required in Takeovers Documents?: Applying Relevance & Reliability*” (2001) 19 C&SLJ 26.

This body of materials can be criticised for its failure to approach the disclosure issue without a sufficient grounding in the historical liability analysis surrounding the making of disclosures of soft information.

courts in the takeovers context and has now been raised before the Australian Takeovers Panel.<sup>141</sup> The cases have concerned the question of whether a requirement to disclose prospects or other material information in a takeover disclosure document requires inclusion of financial forecasts or other soft information. The offeror in a scrip takeover must meet a prospectus standard of disclosure.<sup>142</sup>

The first case in the series was *Pancontinental Mining Ltd v Goldfields Ltd*<sup>143</sup>. This case involved a scrip takeover by a company proposed to be listed on Australian Stock Exchange following the successful offer.<sup>144</sup> As such, the general prospectus disclosure standard applied. The offer document was challenged on the basis, among other things, that it did not include a financial forecast (although it contained a general discussion of the prospects of the issuer) and that it failed to include a discounted cashflow analysis of the present value of the assets of the issuer. It is important to appreciate at the outset that Tamberlin J found that there was a need to include a financial forecast in the takeover disclosure document for the offeror following its acquisition of the target but did not find the need to include a discounted cashflow analysis in the disclosure document.

It was clearly quite significant to the outcome of this case that the issuer of the securities had no stock market history and it was left to target shareholders to assess the value of the consideration offered to them. In addition, the position was complicated because one aspect of the restructuring of the issuer of securities contained an underwritten offer of securities convertible into the shares offered under the takeover.<sup>145</sup>

On the question of a financial forecast, detailed evidence was led concerning the practice adopted by producing gold mining companies issuing prospectuses in initial public offerings. Eight such prospectuses were exhibited in evidence and in all eight there were earning forecasts for either

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<sup>141</sup> The reason for litigation in the takeovers context arises from the strategic advantages for a target company in having an offer delayed by litigation while alternative strategies can be developed.

<sup>142</sup> Section 636(1)(g) of the *Corporations Act*. Following the *CLERP Act* rewrite the separate obligation to disclose other “material information” need not extend to information relating to the value of securities offered as consideration (section 636(1)(m)(iii)).

<sup>143</sup> *Pancontinental Mining Ltd v Goldfields Ltd* (1995) 16 ACSR 463 (FCA, Tamberlin J).

<sup>144</sup> The offeror was a subsidiary of a listed company. The parent company was a diversified mining company. The offer also involved a complex financial restructuring involving the offeror and the sale of the target’s non-gold assets following the takeover. The objective of the takeover was to establish a pure gold producing listing company that was anticipated would trade at a premium to the share price of a diversified mining company - *Ibid* at 485.

<sup>145</sup> As such, the underwritten price represented one way of valuing the offer consideration - *Ibid* at 483. In addition to the inadequacies to the offer document discussed below, the failure to ascertain how the underwritten price was arrived at was considered by Tamberlin J to constitute a material omission from the offer document - *Ibid* at 483-4.

the coming year or for two years. The expert evidence from both parties acknowledged that recent initial public offerings contained this type of information and that information of this type is helpful to investors. The conclusion drawn by Tamberlin J was that the takeover disclosure document was deficient because a forecast of earnings and dividend would be required by a reasonable investor:

“I am of the view that Pancontinental [the target] and its offeree shareholders are entitled under the law to the benefit of an earnings forecast over, at least, a two year period. The fact that each of the recent eight mining company prospectuses, referred to by Mr Duffin, contain earnings forecasts supports the view that such forecasts are material information and are regarded as such by mining companies and their advisers. Such a forecast would be likely to be of real and material assistance to show offerees what they may receive. Even if it is based on a number of assumptions, these assumptions and qualifications can be spelt out.”<sup>146</sup>

Tamberlin J did however stress the fact specific nature of his finding:

“This is not to say that such information is essential under s750 in every case as a matter of law. What is material in a takeover scheme is a matter for judgment and assessment in the light of all the evidence, facts and circumstances in each particular takeover context and this will necessarily differ from case to case. Differing circumstances can include, for example, matters such as relevant public information available, material already disclosed by the offeror, the activities of the target company and the location of those activities; and the probable knowledge or awareness of the shareholders in the target company as to particular subject matters.”<sup>147</sup>

On the other hand, the argument that a discounted cashflow analysis of the value of the assets of the offeror following the takeover should be included was rejected. Only one producing gold mining company prospectus that was exhibited contained such information. In addition, the evidence established that the use of net present value as a valuation methodology in the gold sector was controversial and subject to significant uncertainties and difficulties, as well as the need to forecast financial performance over a much longer period as a basis for that valuation technique.<sup>148</sup>

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<sup>146</sup> Ibid at 471.

An argument that most of the basic information necessary to the creation of a financial forecast by an investor was spread out through the document was rejected on the basis that an offeree, when faced with a complex and lengthy prospectus (the Goldfields document was more than 250 pages long), should not have to forage through the document to seek fragments of information to piece together the assumptions and construct a forecast - Ibid at 472.

<sup>147</sup> Ibid at 475.

<sup>148</sup> Ibid at 471.

An interesting postscript to the *Goldfields Case* is that the issuer failed to achieve its forecast by a very material margin.<sup>149</sup>

Shortly after, in the case of *Soloman Pacific Resources NL v Acacia Resources Ltd*,<sup>150</sup> a takeover offer document was challenged because of a failure to include an earnings forecast or cashflow projections for the offeror following the takeover. The takeover offer document was subject to the continuous disclosure prospectus standard.<sup>151</sup> The application before the court was for an interlocutory injunction to restrain the dispatch of the offer document. In a short judgment denying the injunction McLelland J made the following observation in relation to the inclusion of a financial forecast:

“It was said that information of this kind is necessary in order to enable Solpac [the target] shareholders to assess the financial prospects of Acacia [the offeror], including its prospects for future growth and expansion....In my view, there is for present purposes a significant distinction to be drawn between facts and predictions. Predictions, whether in the form of forecasts or projections or in any other form, are inherently speculative and subject to contingencies of varying degrees of probability and foreseeability. The very inclusion in a Part A Statement of such a prediction might well be potentially misleading. There is no evidence as to what earnings forecasts or cashflow projections might exist or how reliable they might be. I am not persuaded that this alleged deficiency is sufficiently clear or significant to justify the ground of an interlocutory injunction.”<sup>152</sup>

It will be seen that the above comments are philosophically consistent with the historical liability regime described above relating to the need to draw a distinction between statements of fact and soft information. The commentary of McLelland J is remarkably brief for such an important question, particularly having regard to the debate created by the *Goldfields Case*. The *Goldfields Case* was not referred to by McLelland J in his decision.

In *Primac Holdings Ltd*<sup>153</sup> a scrip takeover disclosure document had included a financial forecast of the offeror on a standalone basis, without giving effect to the acquisition of the target.<sup>154</sup> The

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<sup>149</sup> The forecast in the offer document was for 1995/6 after tax profit of \$35-\$48 million. The actual result was \$14.1 million (\$11.1 million before abnormals). The forecast in the offer document was for 1996/7 after tax profit of \$42-\$59 million. The actual result was a loss of \$17.3 million (a profit of \$12.3 million before abnormals).

<sup>150</sup> *Soloman Pacific Resources NL v Acacia Resources Ltd* (1996) 19 ACSR 238 (SC NSW, McLelland CJ).

<sup>151</sup> The argument on inclusion of financial forecasts would seem to have primarily been argued to be required through the necessity in a takeover disclosure document to include other “material information” to the decision of a target shareholder whether or not to accept the offer (the then clause 17 of Part A in section 750 of the *Corporations Law*) rather than the continuous disclosure prospectus standard.

<sup>152</sup> *Ibid* at 242.

<sup>153</sup> *In the Matter of the Corporations Law and In the Matter of Primac Holdings Ltd* (1996) 22 ACSR 212 (SC Qld, Dowsett J) and *Primac Holdings Ltd v IAMA Ltd & Ors* (1996) 22 ACSR 454 (SC Qld, Dowsett J).

disclosure document separately contained a pro forma consolidated historical balance sheet of the combined entities assuming the successful completion of the offer and also contained a statement that it was expected that the acquisition would not dilute the offeror's earnings per share in the coming year. The target challenged the adequacy of disclosure in the offer document on the basis of non-inclusion of a combined forecast, the failure to provide information on the value of the target and offeror shares as well as challenges to the soft information that had been included.

Dowsett J would appear not to have considered it necessary to incorporate a financial forecast for the offeror on either a stand alone or combined basis. He said in that regard that:

“I do not wish to be taken as advocating the making of prediction of this kind in takeover offers”.<sup>155</sup>

However, he said once such a forecast is made:

“the offerees must be given the information necessary to assess their reliability.”<sup>156</sup>

As with the *Solpac case*, no comment was made as to the *Goldfields case* or how its findings should be distinguished. The findings of Dowsett J are quite opaque as to what was meant by him not to be taken to advocate the making of forecast predictions in takeover disclosure documents.

An argument that the offeror's estimate of the value of target shares should be disclosed was also rejected.<sup>157</sup> Dowsett J considered that while there could be little doubt that an offeree would like to know how the offeror reached its decision on the value of target shares, the obligation to disclose material information is concerned with information, not opinions based on information, and:

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<sup>154</sup> A continuous disclosure prospectus standard applied to the offeror and therefore the focus of argument was on the effect of the offer on the offeror.

<sup>155</sup> Ibid at 221.

<sup>156</sup> Ibid. On this basis the takeover document was found to be deficient and an injunction was granted.

<sup>157</sup> The issue of value arose because the then market price of target shares exceeded the offerors market price and the most recent earning per share of the target (after abnormal items) exceeded the earnings per share of the offeror. Despite this the proposed takeover terms were for 9 offeror shares for each 10 target shares.

“does not compel the disclosure of the judgment process as opposed to the facts upon which it is based.”<sup>158</sup>

This comment displays a similar regard to the historical distinction between facts and opinions that underpins the comments made in the *Solpac* Case.

A series of later cases involving cash takeover offers strongly rejected the need to include forecasts or valuation information in cash takeover documents. The targets had clearly been motivated to run these arguments based on the *Goldfields* Case analogy and with an expectation that (despite the suggestions of McLelland J in the *Solpac* Case) that a bidder would have generated this type of information.

The best illustration of this approach is in *Aberfoyle Ltd v Western Metals Ltd*<sup>159</sup> where it was argued by the target that the obligation to disclose other “material information” for a cash takeover required disclosure by the offeror of the following types of soft information:

- the offeror’s rationale for the acquisition and the benefits that would accrue to the target and its shareholders from the acquisition;
- the economic assumptions underlying the offer price, including commodity price assumptions for the minerals mined by the target and foreign exchange rates;
- earnings and cash flow projections prepared by the offeror;
- information concerning technical reports that have been prepared by the offeror from publicly available information for the purposes of obtaining funding from its banks for the purposes of the offer.

Finkelstein J noted that it will frequently be the case that the offeror will have undertaken an evaluation of the worth of the target shares and the price that the offeror is prepared to pay for those shares, but that evaluation is likely to be only one component, and not necessarily a material component, of the offeror’s bidding strategy.

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<sup>158</sup> Ibid at 219. There was no evidence before the Court as to the method of valuation adopted by the offeror’s directors - a variety of possible valuation methodologies were hypothesised by the judge from, at the one hand educated guess to, on the other hand, a detailed valuation exercise.

<sup>159</sup> *Aberfoyle Ltd v Western Metals Ltd* (1998) 28 ACSR 187 (FCA, Finkelstein J).

Finkelstein J noted the subjectivity and potential unreliability of information of this nature and stated that

“cl 17 does not require an offeror to disclose its evaluation of the shares or the economic assumptions upon which that evaluation has been based. Speaking strictly cl 17 is concerned with the disclosure of facts and circumstances of which the offeror is aware and not with the disclosure of matters of opinion about which minds may differ, assessments that are based on variable assumptions or predictions or the assumptions or predictions upon which those assessments are based. Speaking generally, I would not regard the disclosure of such opinions, assessments etc to be of much assistance to a shareholder. The accuracy or reliability of the opinions, assessments, etc would often be the subject of challenge and debate. Rarely will shareholders have the ability or the capacity to evaluate competing opinions, assessments, etc or the criticisms that might be made of them. Thus, the disclosure of such “information” would not usually assist a shareholder in making an informed decision whether to sell his shares”.<sup>160</sup>

Finkelstein J said that there may be cases where information of that nature would be of assistance to shareholders, but that the case before him was not such a case.<sup>161</sup>

This case law therefore makes it quite clear that, in the absence of an obligation to disclose the prospects of a bidder, the general requirement to disclose material information relating to the bid does not require the disclosure of prospective financial information or statements of the bidders opinions.

The question of disclosure of prospects in a scrip offer document was returned to in *GIO v AMP Insurance*.<sup>162</sup> The bidder had included in the document a stand alone forecast until the end of the current financial year (a period of approximately three months) but no combined entity forecast

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<sup>160</sup> Ibid at 210.

The takeovers case law had for a significant period expressed the view that the disclosure of speculative information is not required by the disclosure requirements imposed on takeover disclosure documents and should be avoided - see for example *ICAL Ltd v County NatWest Securities Aust Ltd & Anor* (1988) 12 ACLR 129 (SCNSW, Bryson J) at 147; *Australian Consolidated Investments Ltd v Rossington Holdings Pty Ltd* (1992) 7 ACSR 341 (FCA, Davies Sheppard & Beaumont JJ) at 342.

By way of comparative analysis it is generally considered that the US securities laws impose no general obligation to disclose forward looking information such as internal projections and forecasts - see *In re VeriFone Securities Litigation* 11 F 3d 865 (9th Cir, 1993); *In re Convergent Technologies Securities Litigation* 948 F 2d 507 (9th Cir, 1991).

<sup>161</sup> Again, in *Savage Resources Ltd v Pasmenco Investments Pty Ltd & Ors* (1998) 30 ACSR 1 (FCA, Hely J) (the takeover involved a cash offer), the proposition was rejected that an offeror should be expected to disclose how high it might be prepared to bid to secure control (Ibid at 14). It was argued that the acquisition would provide certain undisclosed benefits to the offeror (at 12-3)). Hely J considered it would be an exaggeration to require all perceptions, opinions or assumptions of the offeror to be itemised in the offer document and rejected the assertion that non disclosures had been made in relation to the strategic value of the acquisition to the offeror.

To similar effect see *SGIO Insurance Ltd v Wesfarmers Insurance Investments Pty Ltd* (1998) 29 ACSR 207 (SC, WA, Wallwork J); *Cultus Petroleum NL v OMV Australia Pty Ltd* (1999) 32 ACSR 1 (SCNSW, Santow J) at 11-13; *AAPT Ltd v Cable & Wireless Optus Ltd & Ors* (1994) 32 ACSR 219 (SCNSW, Austin J) at 225-9.

<sup>162</sup> *GIO Australia Holdings Ltd v AMP Insurance Investment Holdings Pty Ltd & Anor* (1998) 29 ACSR 584 (FCA, Emmett J)

of the bidder and the target. The bidder stated in the offer document that for a variety of reasons it was unable to provide a combined entity forecast.<sup>163</sup> The evidence established that the bidder had prepared internal projections of the combined entity financial results.

Emmett J found that a combined entity forecast was not required in the circumstances. However, in doing so he made the point that if a combined entity forecast had been released in a document with appropriate qualifications and underlying assumptions, the disclosure of that information would have not been misleading.<sup>164</sup>

Reliance was had to the comments of *Pancontinental v Goldfields* as to the necessity to make a decision on the inclusion of the forecast based on the circumstances of each case. In that connection regard was had to uncertainties that concerned the bidder surrounding the preparation of a forecast for the target, particularly the impact of volatility of equity markets on the targets financial position and the other circumstances surrounding the release of financial information on the target. Emmett J did not consider the evidence established that the bidder sought to withhold information which might dissuade shareholders from accepting the offers or accepting the scrip alternative that had been offered. On this basis the non-inclusion of the confidential internal projections was considered justified:

“if those responsible for the finalisation of the form of the AMP Part A statement... exercised judgment as to whether or not they were satisfied that the public information concerning GIO was sufficiently reliable to justify including a forecast of the profits for the combined entity, I am not persuaded by the evidence that that judgment was made wrongly”.<sup>165</sup>

The length of the stand-alone forecast was also challenged on the basis that initial public offerings frequently involved a forecast period significantly longer than the three months set out in the offer document. Emmett J considered that it was justifiable for an insurance company to limit its forecast to the end of the current financial year having regard to the impact of mark to

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The offer was for cash or alternatively scrip. As the bidders parent had been listed on ASX for less than a year, the general prospectus disclosure standard applied to it.

<sup>163</sup> The reasons were that the target had not released a financial forecast to the market and uncertainty in the market surrounding the target's financial performance (given the target had surprised the market by disclosing a loss when a profit had been expected by analysts) - Ibid at 621.

The stand alone forecast restated and confirmed a forecast range contained in an initial public offering prospectus that had been released by the bidders parent earlier that year.

<sup>164</sup> Ibid at 623.

<sup>165</sup> Ibid at 624-5

market accounting on the results of those companies and the impact of volatility in financial markets.<sup>166</sup>

Since the enactment of the *CLERP Act* in March 2000 the resolution of disputes in relation to takeover bids is intended to be determined by the Takeovers Panel. The disclosure of forward looking information has been the subject of consideration by the Takeovers Panel. However, the usefulness of that material has been limited by the conclusory nature of the decisions exhibited in the findings of the panel as compared with judicial decisions.<sup>167</sup>

In *Infratil Australia Limited*<sup>168</sup> a scrip offer document was challenged on the basis of the absence of financial projections for the merged entity.<sup>169</sup> The panel cited the *Pancontinental Case* as authority for the view that where meaningful projections can be made they should be provided. However, because of the unusual circumstances affecting the bidder, the failure to include a

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<sup>166</sup> Emmett J considered this approach reasonable so long as the end of the current financial period was not “immediately imminent” - *Ibid* at 620. See also at (1998) 30 ACSR 97 (FCA, Emmett J) for the subsequent orders made following significant delays caused by the litigation (the end of the forecast period had by then become imminent). The offer document only included a stand-alone forecast for the offeror until the end of the current financial year. The circumstances were therefore analogous to the *Primac* case.

A similar approach to the *GIO* case was reflected in the subsequent case of *Wesfi Ltd v Blend Investments Pty Ltd* (1999) 31 ACSR 69 (SC WA, Wheeler J)

Wheeler J confirmed the by now well accepted distinction between information and speculation:

“the duty is a duty to disclose information, not speculation. Disclosure of information would include disclosure of assumptions upon which any forecasts or assessments are made and, where it exists, disclosure of information relevant to the question of whether assumptions are likely to be correct. Put another way, while speculation is not required and is generally to be discouraged, where speculative or predictive material is included, there should be some means of assessing that material”. (*ibid* at 70)

The approach adopted in the *GIO* case was accepted as applicable (the offeror stated it only had publicly available information on the target for forecasting purposes and that there were difficulties in preparing such a forecast) with the proposition advanced by Wheeler J that any forecast prepared for internal use would in the current circumstances not be reasonably required to be provided in the offer document. *Ibid* at 72. Wheeler J further said in the circumstances of the case the inclusion of such information would risk confusing or misleading the reader.

<sup>167</sup> In fairness to the panel it does not see itself as replicating court processes but instead reaching a speedy commercial resolution of takeover disputes guided by the principles set out in section 602 of the *Corporations Act* (the so called Eggleston Principles that include, from a disclosure perspective, that shareholders receive sufficient information to assess the merits of the offer - see *In the Matter of Pinnacle VRB Limited (No 8)* (038/01 decided 22 June 2001, available at [www.takeovers.gov.au](http://www.takeovers.gov.au)) at paragraph 54 - 56).

<sup>168</sup> *In the Matter of Infratil Australia Limited(No 2)* (002/00 decided 9 May 2000, available at [www.takeovers.gov.au](http://www.takeovers.gov.au))

<sup>169</sup> The target and the bidder were both investors in infrastructure projects. The bidders statement contained a pro-forma consolidated balance sheet but did not contain historical profit information or any statement relating to the maintainability of profit levels (at para 28).

financial projection was accepted as adequate disclosure in the circumstances.<sup>170</sup> The panel did require that reasons for nondisclosure be given if no forecast was provided.<sup>171</sup>

The presumption of the desirability of forecast financial information was further affirmed by the panel in *Vincorp Wineries Limited*.<sup>172</sup> The *Vincorp* decision reflects an approach analogous to the *AMP Case*.<sup>173</sup> The panel said it will not require the bidders statement to contain a forecast where the bidder does not have reasonable grounds for providing the forecast. However where the bidder does have reasonable grounds the information should be provided. Again, if not provided, the uncertainties preventing disclosure should be explained.<sup>174</sup>

As such, while the Takeovers Panel has repeatedly affirmed its expectation that a forecast be included in scrip takeover documents it has not ordered the disclosure of such a forecast where the bidder has elected not to make disclosure.

### ASIC Position

In *Practice Note 67*<sup>175</sup> ASIC has summarised its position on the need to include a financial forecast as follows:

“This Practice Note does not set out when a forecast must be included in a prospectus. Directors must assess this on a case-by-case basis. However, the ASC considers that when directors consider that they do not have a reasonable basis for a reliable forecast then:

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<sup>170</sup> The panel noted that in, the context of the bidder, the market value and cashflows of assets could be made with a degree of confidence. However, the bidder’s trust deed required that financial results were derived from revaluations of assets from period to period conducted by an independent expert. On this basis it was not considered possible to prepare a financial projection consistent with prior financial periods until the relevant revaluations had occurred (at paragraph 34).

<sup>171</sup> At paragraph 34. That view echoes the *AMP case* and the *Wesfi case*.

<sup>172</sup> *In the Matter of Vincorp Wineries Limited* (027/01 decided 26 June 2001, available at [www.takeovers.gov.au](http://www.takeovers.gov.au)).

In the earlier decisions of *In the Matter of Email Limited (No 3)* (0003/00 decided 28 June 2000, available at [www.takeovers.gov.au](http://www.takeovers.gov.au)) and *In the Matter of Brickworks Limited (No 2)* (009/00 decided 10 October 2000, available at [www.takeovers.gov.au](http://www.takeovers.gov.au)) the materiality of prospective financial information was noted in the context of the offering of securities (at paragraph 106 and 27 respectively). However, the complexities at each bid complicated the analysis. Financial forecasts were not required in either case (pro forma historical information was considered adequate).

<sup>173</sup> At paragraph 44.

<sup>174</sup> It was significant that the bidder had undertaken a change in activities since its last balance. This resulted in historical performance not being indicative of future results. The panel accepted there were significant uncertainties in projecting financial performance. No financial forecast was required, although a descriptive disclosure of likely performance and a pro forma balance sheet was required.

<sup>175</sup> Practice Note 67 “*Financial Forecasts in Prospectuses*” (issued 4/8/1997).

This practice note is expected to be replaced in 2002 by proposed Policy Statement 170 “*Prospective Financial Information*” (consultation draft released for comments on 12 December 2001). The key aspects of the analysis in Practice Note 67 are unchanged in the consultation draft. The draft contains further elaboration by ASIC as to its views as to considerations relevant to the reasonableness and disclosure of underlying assumptions.

- (a) no forecast should be included; and
- (b) a forecast will not be required by s.996 or s.1022 of the Law.

Directors should not include a forecast without a reasonable basis, even if they have used estimates of future performance for internal planning purposes or if comparable issuers have included forecasts in their prospectuses. A forecast that does not have a reasonable basis would not be material to investors, nor would an investor reasonably require it or reasonably expect to find it in a prospectus.”<sup>176</sup>

As to the content of a financial forecast when made the ASIC makes the following observations:

“An investor must be able to make an informed assessment of the reliability of a forecast. Therefore they must be able to assess:

- (a) the validity of the assumptions on which the forecast is based;
- (b) the likelihood of the assumptions actually occurring; and
- (c) the effect on the forecast if the assumptions vary.

The ASC recognises that excessive amounts of information should not be included in prospectuses because it makes them less comprehensible. However, the ASC considers that a prospectus must give investors enough information to assess any forecast it contains.”<sup>177</sup>

The Practice Note was promulgated following the delivery of the *Goldfields* case and the *Solpac* case at a time of public controversy as to the requirements for the disclosure of prospects as a result of those cases. The Practice Note was cited with approval by the court in the *GIO* case.

The approach of ASIC as reflected in the Practice Note seems correct as a matter of technical analysis of the state of the Australia case law. What the ASIC materials fail to do is provide any degree of certainty as to when a financial forecast is required.

### **United Kingdom and other Commonwealth country comparison**

Before attempting to draw conclusions on the Australia position in relation to financial forecasts it is helpful to undertake a comparative analysis with other disclosure regimes.

In England the common law treatment of soft information is as outlined above. The current United Kingdom regime reflects a general reluctance to include forward looking information in

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<sup>176</sup> PN 67.2 (see also draft Policy Statement 170.5).

<sup>177</sup> PN 67.3 (see also draft Policy Statement 170.38).

disclosure documents, despite recommendations from reform bodies suggesting the desirability of the inclusion of such information.<sup>178</sup> This reluctance to disclose arises despite the largely identical disclosure standard in the *Financial Services Act 1986* requiring the disclosure of “prospects”.

The reluctance to disclose financial forecasts arises because of the strictness of the rules of the London Stock Exchange in connection with the inclusion of profit forecasts in a prospectus.<sup>179</sup> Under these requirements where a profit forecast is included in a prospectus the principle assumptions upon which the profit forecast is based must be stated. A report from an accountant or auditor must be included in the prospectus reporting on whether the forecast has been compiled on the basis disclosed and whether the forecasts is consistent with the accounting policies adopted by the issuer.<sup>180</sup>

Notwithstanding the academic support for relaxation of these provisions so as to encourage the inclusion in prospectuses of more forward looking information, there has been no movements to date to do so.

Similarly, in Ontario any projection must be based on assumptions that reflect the entities’ plans for the period covered.<sup>181</sup> The forecast must be supported by an accountants review of the statement and must be prepared in accordance with accounting standards and with disclosure of

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<sup>178</sup> See description in Note (McBride & Co Pierson) “*Management Discussion and Analysis*” (1996) 14 C&SLJ 449 at 451.

The obligation to make disclosure of “prospects” is elaborated on in the Listing Rules of the London Stock Exchange through general information of the trends in the business since the last published financial statements as well as special trade factors or risks that could materially affect profits that are unlikely to be known or anticipated by the general public - see Listing Rule 6.G.1.

<sup>179</sup> As set out in Chapter 12 of the Listing Rules of the London Stock Exchange. See also to similar effect the Appendix to the Unlisted Securities Market Rules.

For these purposes a profit forecast includes any words that expressly or impliedly state a minimum or maximum likely level of profits or contain information from which an approximate estimate of profits could be made - Listing Rule 12.23.

<sup>180</sup> In addition, the “sponsor” (the member of the London Stock Exchange responsible for sponsoring the listing (typically the underwriters) must confirm to the UK Listing Authority that the forecast has been made after due and careful inquiry by the directors (Listing Rule 6.G.2). This responsibility is expressed to be owed solely to the UK Listing Authority. However the liability consequences imposed on the sponsor under the *Financial Services and Markets Act 2000* by giving this certification are unclear - see *Gleeson & Blomenthal (1999)* at 411 - 2.

<sup>181</sup> See Regulation 60 of the *Securities Act Regulations* of Ontario and CSA Notices Number 48.

Generally the forecast cannot extend beyond the end of the next full financial year. The issuer has a duty to update the forecast every time financial statements are produced and explain significant differences. An immediate disclosure obligation arises if there is a material change of events or assumptions.

For discussion see *Rodier (1985)* at 42 - 4; *Johnston & Rockwell (1998)* at 77; *Campbell (1993)* at 350 - 3; *Rousseau (2000)* at 748 - 750.

the significant assumptions underlying the forecast. As such, the Canadian approach is very similar to the United Kingdom in requiring high standards of certainty before disclosure of a forecast is permitted.<sup>182</sup>

Again, in New Zealand where a financial forecast is included in a prospectus the prospectus must contain a statement of the principal assumptions on which it is based and the auditors report must include a statement that the forecast has been properly compiled on the basis of the assumptions made.<sup>183</sup>

### United States comparison

A different history and approach is evident in the United States.

The United States common law applied liability rules to soft information that are generally consistent with the United Kingdom/Australian approach described above.<sup>184</sup> Statements of intention and opinion have historically been considered immaterial as a general matter, although liability may be established if there is misstatement of an underlying fact.

In the securities law context the practice in the United States has not been for prospectuses to include significant forward looking information and rarely, if ever, to include financial forecasts. An appreciation of the United States practice requires regard to be had to historic considerations.

In the 40 years following the establishment of the Securities Exchange Commission, the SEC adopted a philosophic approach of requiring prospectuses only to contain hard information so as to assure a high degree of reliability.<sup>185</sup> The philosophy of the SEC was to protect investors, particularly unsophisticated investors, from questionable selling literature and to ensure the

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<sup>182</sup> The predictable result is a chilling effect on disclosure in formal disclosure documents and likely selective disclosure to institutional advisors - see *Campbell* (1993) at 353 and 358 and *Rodier* (1985) at 43. For advocacy of mandatory disclosure of forecasting in Canada see *Campbell* (1993) at 354 - 8.

Ontario also borrows from the United States legislation in requiring the disclosure of forward looking management discussion & analysis (*M, D & A*) in preparing financial statements (see Ontario Securities Commission "*Policy Statement 5.10*" (promulgated 1990) and discussed in *Campbell* (1993) at 331 - 349.

<sup>183</sup> See Regulation 5 of the *Securities Regulations* (New Zealand). For discussion see *Mak* (1994) at 142 - 4.

In 1990 a report prepared for the Securities Commission "*Profit Forecasts Disclosure in New Zealand Prospectuses*" suggested that New Zealand forecasts were less accurate than in other jurisdictions. Various reform proposals were proposed by the Securities Commission and set out in discussion papers in 1991 ("*The Regulation of Profit Forecasts and Other Forecast Information in Prospectuses for Equity Securities*") and in 1993 ("*The Regulation of Prospective Financial Information and Other Information in Registered Prospectuses - Proposals for Reform*") but were not acted upon.

<sup>184</sup> For early authority see the discussion of cases in *Shulman* (1933) at 235 - 238 and cases such as *Crosby v Emerson* 142 F 713 (3d Cir, 1906) and *Zeh v Alameda Community Hotel Corp* 10P (2d) 190 (1932) which deal with similar facts and reach similar conclusions as the old English authorities such as *Bellairs v Tucker* discussed above.

disclosure of the basic historic and objectively verifiable information that was considered by the SEC to be essential to investment analysis.<sup>186</sup>

In addition, there was a strong expectation that the securities laws would create significant liability for forecasts that become inaccurate, so that the common law position had ceased to prevail.<sup>187</sup>

As has been discussed at greater length in Chapter 1, during the 1960s and 1970s the orthodoxy of the SEC's position was strongly challenged by a number of securities law commentators.<sup>188</sup> Among the criticisms made was the view that the disclosure of soft information was critical to proper investment analysis. As such, it was suggested that the liability rules be modified to encourage the making available of soft information.<sup>189</sup> It was perceived that because soft information is not verifiable, the onus imposed by the statutory liability provisions might be too harsh.

To encourage the disclosure of soft information it was suggested by commentators that where soft information has a reasonable basis, represents a good faith expectation of the maker and major assumptions are articulated, there should not be liability.<sup>190</sup>

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<sup>185</sup> See *Schnieder* (1972) at 258; *Anderson* (1974) at 331 - 342; *Seligman* (1995) at 1954 - 5.

<sup>186</sup> See R. Heller "Disclosure Requirements Under Federal Securities Regulation" (1961) 16 Bus Law 307 and R. L. Knauss "Disclosure Requirements - Change in Concepts of Liability" (1968) 24 Bus Law 43.

<sup>187</sup> In 1969 the *Wheat Report* ("Disclosure to Investors: A Re-appraisal of Federal Administrative Policies Under the '33 and '34 Acts", 1969, Securities Exchange Commission) suggested that "problems of civil liability would be insurmountable unless projections in prospectuses were expressly granted immunity" (at 95). While this seems a fairly extreme reaction having regard to the common law analysis the view is supported by case law from the time such as *Union Pacific Railway v Chicago & Northwestern Railway* 226 F Supp 400 (ND Ill, 1964) (predicted synergy benefits from a merger would have misleading effect on the public - at 408 - 9); *GM, Inc v Newbern* 488 F 2d 742 (9th Cir, 1973) (forecasts should be considered as "facts" for securities law purposes). A further prominent example is the *Feit Case* where issuer estimates of reserves held by a target company were considered material without any discussion of the soft information issues that arose (*Feit Case* at 571 - 2, discussed in section 7.2 below). See also *In Re Donald J Trump Casino Securities Litigation - Taj Mahal Litigation* 7 F 3d 357 (3d Cir 1993) at 368. Indeed, the *ALI Federal Code* had proposed a legislative formalisation that soft information constituted a "fact" for misstatement purposes - see proposed section 256 and section 297.

On the other hand other case law suggests a more moderate approach consistent with Australian case law where liability requires that the statement not be genuinely believed, there is no reasonable basis for the belief or that there are undisclosed facts undermining the statement - see *In Re Apple Computer Securities Litigation* 886 F2d 1109 at 1113 and *Weilgos v Commonwealth Edison Co* 892 F 2d 509 (7th Cir 1989) at 513; *Virginia Bankshares, Inc v Sandberg* 111 S Ct 2749 (1991).

For discussion see *Rosen* (1995) at 22 - 29; *Schneider* (1993) at 34 - 5.

<sup>188</sup> In relation to the disclosure of financial forecasts see advocates such as *Kripke* (1970) at 1197 - 1201; *Schneider* (1972); H. Manne "Prospectuses: Unreadable or Just Unread" - A Proposal to Re-examine Policies Against Permitting Projections" (1972) 40 Geo Wash L Rev 222.

<sup>189</sup> See *Schneider* (1972) at 280 - 3.

<sup>190</sup> See for example *Schnieder* (1972) at 277.

It is important to note that the foregoing is not to suggest that forward looking information was not available to potential investors. The United States practice was to make available such information, primarily to institutional investors, through disclosures made outside the prospectus orally at selling presentations.<sup>191</sup> The perceived advantage of this approach under the United States liability rules is that unlike section 11 and section 12(2) liability which is negligence based, general anti-fraud liability under section 10(b) of the Exchange Act is fraud based. Under Rule 10b-5 a financial projection made in good faith is not made with the scienter required to establish liability if the projection turns out to be faulty.<sup>192</sup>

Of course, such a regime has little to commend itself from the policy perspective. The approach leads to an information asymmetry between classes of investors (even if the investors with the information are price setters of securities rather than price takers). If it is accepted that mandatory disclosure is a good thing, it is the most relevant information to decision-making that should be included within the statutory document.<sup>193</sup>

From the time of that debate there have been a number of developments in the United States intended to encourage greater availability of soft information, both from the perspective of the disclosure regime as well as the liability regime.<sup>194</sup>

The primary focus of changes to the formal disclosure requirements of the US regime has been to require greater forward looking disclosure in the management discussion and analysis<sup>195</sup> sections

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<sup>191</sup> The practice is described in *McLaughlin (1993)* at 75.

Earnings projections are generally provided to investors at the roadshow by the lead underwriter. The projections are typically made by the lead underwriters' analyst on the basis of discussions with management. To avoid a violation of section 5 of the *Securities Act* the projections are provided orally.

See also the description in *Schnieder (1972)* at 270; Comment (K. Till) "*The SEC Safe Harbour for Forecasts - A Step in the Right Direction?*" (1980) Duke LJ 607 at 612 - 3; the facts of *Weinberger v Jackson, et al* [1991 Transfer Binder] CCH Fed Sec L Rep 95, 693 (ND Cal).

<sup>192</sup> See *In Re Software Toolworks, Inc Securities Litigation* 789 F Supp 1489 (ND Cal 1992) at 1500 - 1; *In Re Apple Computer Securities Litigation* 886 F 2 D 1109 (9th Cir 1989); *In Re Comvergant Technologies Securities Litigation* 948 F 2d 507 (9th Cir 1991); *In Re Ann Taylor Stores Securities Litigation* [1992 Transfer Binder] CCH Fed Sec L Rep 96,940 (SDNY).

<sup>193</sup> Regulation FD promulgated under the *Securities Exchange Act* 1934 now partly deals with this issue by requiring the public disclosure of all material nonpublic information regarding an issuer or its securities that are disclosed by an issuer to certain specified securities market professionals.

Perplexingly from the policy perspective, disclosures made in connection with a registration statement are excluded: Rule 100(a)(2)(iv) of Regulation FD. However, the exception is explained by reference to the practices described in the footnote above.

<sup>194</sup> In 1973 the SEC announced that it had decided to change its approach to the disclosure of soft information - Securities Act Release 5362. In 1978 the SEC adopted the position encouraging the inclusion of projections in SEC filings - Securities Act Release 5992.

For a general summary see *Seligman (1995)* at 1956 - 1962.

of disclosure documents, including prospectuses, filed with the Securities and Exchange Commission.<sup>196</sup> MD&A disclosure now requires disclosure of known trends affecting the business that are known to or will reasonably be expected to have a material impact on profitability or which may cause historical financial information to be a poor indicator of future performance.<sup>197</sup> Disclosure of additional forward looking information is encouraged, but not required.<sup>198</sup>

The scope of the United States mandatory disclosure rules can currently be characterised as a tentative step towards prospective disclosure as compared to the Australian practice of inclusion of detailed financial forecasts. The practice of disclosing projections outside the prospectus continues in the United States. United States courts have consistently refused to impose a duty to disclose internal projections under the securities law.<sup>199</sup> By way of analogue to the Australian position reflected in *AMP v GIO*, in *Panter v Marshall Field*<sup>200</sup> it was held disclosure of projections would only be required if they were “reasonably certain”.<sup>201</sup>

On the other hand, there have been significant developments in the United States in relation to liability rules. Those developments are the establishment by the SEC of a safe harbour for forward looking information in the late 1970s, the development of the “bespeaks caution” doctrine by United States courts over the last decade and the introduction of specific statutory defences in the *Securities Act* 1933 in 1995.

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<sup>195</sup> Referred to by the customary acronym “MD&A”.

<sup>196</sup> Regulation S-K promulgated by the SEC under the *Securities Act* and the *Securities Exchange Act*.

<sup>197</sup> Contained in Item 303, particularly instructions 3 and 5. Interpreted by *Securities Act* releases 31-6711 (24 April 1987) and 33-6835 (8 May 1989) and Exchange Act releases 26,831 (18 May 1989) and 34,831 (13 October 1994). For discussion see *Rosen (1995)* at 7-14; *Seligman (1995)* at 1962-1976.

<sup>198</sup> See instruction 7 to Item 303. The distinction is discussed in the interpretive releases noted *ibid* as well as in SEC administrative proceedings such as *Caterpillar, Inc* (Exchange Act Release 30,532 (31 March 1992)), *Bank of Boston Corp* (Enforcement Release 519 (11 January 1994)) and *In the Matter of Sony Corp* (Exchange Act Release 40,305 (5 August 1998)). For discussion see *Rosen (1995)* and *Seligman (1995)* *Ibid*.

<sup>199</sup> See *In re Lyondell Petrochemical Co Securities Litigation* [1993 Transfer Binder] CCH Fed Sec L Rep 97,335 (9th Cir); *Convergent Technologies Securities Litigation* 948 F 2d 507 (9th Cir 1991); *Aldus Securities Litigation* [1993 Transfer Binder] CCH Fed Sec L Rep 97 376 (WD Wash).

<sup>200</sup> *Panter v Marshall Field & Co* 646 F 2d 271 (7th Cir 1981).

<sup>201</sup> The finding of the court was that it was not a material omission for a report of 9 months earnings to fail to disclose an internal projection suggesting a decline in the last quarter.

See also *Starkman v Marathon Oil Co* 772 F 2d 231 (6th Cir 1985) (must be “substantially certain to hold”).

The United States debate on soft information initially led to the promulgation by the SEC in 1979 of a *Securities Act* rule providing a safe harbour for forward looking statements.<sup>202</sup> Rule 175 provides that a forward looking statement:

“shall be deemed not to be a fraudulent statement....unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith.”

Forward looking statements are defined to mean projections of financial matters, statements of management plans and objectives for future operations, statements of future economic performance contained in MD&A disclosures and statements of assumption underlying or relating to any of those matters.<sup>203</sup>

The question of liability for soft information in the securities law context has further been topical through the development of the so-called “bespeaks caution” doctrine by a number of United States courts over the last decade.<sup>204</sup>

The first expression and development of the doctrine is generally considered to trace from the 1986 decision of *Luce v Edelstein*.<sup>205</sup> The bespeaks caution doctrine can be defined as a mechanism whereby a court can rule as a matter of law that forward looking representations contain sufficient cautionary language to protect the defendant against a securities fraud claim, whether brought under Rule 10b-5 or under sections 11 and 12(2)<sup>206</sup> so as to permit the court to grant summary dismissal of the defendants case on the basis the claim is immaterial as a matter of law.

There is an unresolved debate in the United States as to the limits of the doctrine and whether, for example, the use of boilerplate cautionary language will always negate liability.<sup>207</sup> The better

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<sup>202</sup> 44 Fed Reg 38, 810 (1979)

<sup>203</sup> Rule 175(c).

<sup>204</sup> For general analysis of the bespeaks caution doctrine see *Rosen (1995)*; *Seligman (1995)*; *Langevoort (1994)*; *Schnieder (1993)*; *Bardondes (1993)*; J Eisenberg “*Liability for Faulty Earnings Projections and Optimistic Statements*” (1993) 21 Sec Reg LJ 202.

<sup>205</sup> *Luce v Edelstein* 802 F 2d 49 (2d Cir 1986). The case involved a securities fraud action against promoters of a limited partnership in relation to projections contained in the offering materials as to cash and tax benefits from the venture. The projections were accompanied by disclaimers to the effect that the projections were necessarily speculative and may not be realised.

<sup>206</sup> See *Langevoort (1994)* at 482-3.

<sup>207</sup> See, for example, *Schwartz v Michaels* [1992 Transfer Binder] Fed Sec L Rep (Cir) 96,920 (SDNY 1992). The various circuit courts have adopted various approaches to the doctrine - see the description in *Bardondes (1993)*; *Seligman (1995)* at 1977 - 1981.

For criticism of such an extreme view see *Langevoort (1994)* at 497 - 8.

view is reflected in case laws such as *In Re Donald J Trump Casino Securities Litigation*<sup>208</sup> where the Third Circuit Court of Appeal refused to:

“establish a sweeping rule that cautionary statements will always render misrepresentations or omissions immaterial as a matter of law.”<sup>209</sup>

On this basis the bespeaks caution doctrine can be explained as an acceptance by the courts that properly couched cautionary language qualifies disclosures of soft information made so that the disclosures do not have a propensity to mislead or that, alternatively, the cautionary language removes the reasonableness of reliance by the investor.<sup>210</sup> In the words of the court in *In Re Donald J Trump Casino Securities Litigation*:

“We can state as a general matter that, when an offering document’s forecast, opinions or projections are accompanied by meaningful cautionary statements, the forward looking statements will not form the basis for a securities fraud claim if those statements do not affect the ‘total mix’ of information the document provided investors. In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law....Of course, a vague or blanket (boilerplate) disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate to prevent misinformation. To suffice the cautionary statements must be substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge.”<sup>211</sup>

It would seem likely that, consistent with the bespeaks caution doctrine, liability may be imposed where the forward looking statements were not true or not genuinely believed by their maker.<sup>212</sup>

The approach reflected in the bespeaks caution doctrine has been further developed through the introduction in 1995 of the *Private Securities Litigation Reform Act*,<sup>213</sup> which amends both the

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<sup>208</sup> *In Re Donald J Trump Casino Securities Litigation - Taj Mahal Litigation* 7 F 3d 357 (3d Cir 1993). See also to similar effect *In Re Worlds of Wonder Securities Litigation* 814 F Supp 850 (ND Cal 1993); *Harden v Raffensperper, Hughes & Co* 65 F 3d 1392 (7th Cir 1995).

<sup>209</sup> *Ibid* at 373.

<sup>210</sup> See *Langevoort (1994)* at 487.

<sup>211</sup> *Ibid* at 371-2.

The Court in *In Re Worlds of Wonder Securities Litigation* 814 F Supp 850 (ND Cal 1993) said:

“Estimates or forecasts of future performance in a prospectus are not actionable if the prospectus contains conspicuous language that bespeaks caution as to actual results. Furthermore, the cautionary language must specifically disclose the nature and extent of the risks involved” (at 859).

<sup>212</sup> See *Mayer v Mylod* 1988 F 2d 635 (6th Cir 1993) and *Gurfein v Sovereign Group* [Current Binder] Fed Sec L Rep (CCH) 97, 632 (Ed Pa, 1993). For analysis see *Barondes (1993)* at 279 - 82; *Langevoort (1994)* at 489-492; *Seligman (1995)* at 1978; J. O’Hare “*Good Faith and the Bespeaks Caution Doctrine: Its not just a state of mind*” (1998) 58 *Uni of Pitt L Rev* 619.

<sup>213</sup> Section 102 of the *Private Securities Legislation Reform Act* 1995. For general discussion see C W Schneider & J. A. Dubow “*Forward Looking Information: Navigating in the Safe Harbour*” (1996) 51 *Bus Law* 1071.

*Securities Act*<sup>214</sup> and the *Securities Exchange Act*<sup>215</sup> to provide a safe harbour from liability in private lawsuits for corporate projections and other forward looking statements made by issuers in various contexts. Two different safe harbours are provided for in the legislation:

- where the forward looking statement is identified as such in the document and is accompanied by “meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward looking statement”<sup>216</sup> or where the forward looking statement is “immaterial”; or
- where a plaintiff fails to prove the statement was approved by an executive officer who had actual knowledge that the statement was false and misleading.<sup>217</sup>

The safe harbours further provide that nothing contained in those provisions imposes a duty to update the forward looking statement. These legislative amendments were specifically intended to develop Rule 175 and the judicially created bespeaks caution doctrine.<sup>218</sup> However, curiously from the policy perspective, the safe harbours are specifically excluded from having application to an initial public offering.<sup>219</sup>

Despite these changes, issuers in the United States remain reticent to incorporate financial forecasts in registration statements. The reason for this reticence is that state based laws do not provide for the same safe harbour as is now incorporated in the federal laws so that issuers continue to fear that they remain exposed to liability for a financial forecast, even if made on reasonable grounds.<sup>220</sup>

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<sup>214</sup> Section 27A of the *Securities Act 1933*.

<sup>215</sup> Section 21E of the *Securities Exchange Act 1934*.

<sup>216</sup> For judicial consideration see *In Re Boeing Securities Litigation* 40 F Supp 2d 1160 (WD Wash 1998) where a relatively high standard was required to establish that the cautionary language was meaningful instead of simply boilerplate.

<sup>217</sup> This safe harbour is not available in respect of enforcement actions brought by the SEC.

<sup>218</sup> See “*Joint Explanatory Statement of House - Senate Conference Committee on Private Securities Litigation Reform Act 1995*”, page 43-45. It should be noted that there was a distinction between the bespeaks caution doctrine developed by United States courts and Rule 175 in that Rule 175 does not premise the availability of its defence on the use of any cautionary language. The committee report stresses the need for the cautionary language to identify relevant factors relevant to the projections. The analysis therefore closely follows the approach of courts such as *In Re Donald J Trump Casino Securities Litigation*. The safe harbour for immaterial statements is said to preserve the ability of courts to find statements not actionable on other grounds i.e. on the bespeaks caution approach as developed by the United States courts.

<sup>219</sup> Section 27A(b)(2)(D) of the *Securities Act 1933*.

<sup>220</sup> See SEC “*Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act 1995*” (April 1997) at page 5.

Clearly, the result of the above analysis is to demonstrate to the marked contrast between the Australian position and that of the United States.<sup>221</sup> The question is, which is the more appropriate regime?

### Assessment of Australian position

The significance of soft information to informed decision-making has previously been discussed. It cannot be suggested that there is no great value in that type of information and provided it is properly appreciated by an investor, it should be available.<sup>222</sup>

The issue for assessment is what conclusions can be drawn from the Australian case law and other materials described above following consideration of the above comparative analysis. Having regard to the identical disclosure regime applicable to a prospectus and a scrip takeover disclosure document, the Australian case law as it applies to prospectuses should not be distinguished solely on that basis.

The first point to clearly enunciate is that, even in the area of prospectuses, the *Corporations Act* does not explicitly require the inclusion of financial forecasts.<sup>223</sup> An obligation for disclosure of prospects does not necessarily equate to the need to disclose a financial forecast. Conversely, inclusion of a financial earnings forecast does not obviate the need to disclose prospects.<sup>224</sup> This is a trite point but frequently forgotten in the public debate.

There has been much debate in Australia as to how the *Goldfields* case and the *Solpac* case can be reconciled. What is immediately clear when these cases are considered against the background legal milieu that applies to soft information, is that there is a very different starting point adopted by each of the judges. On this basis it is not possible to reconcile their decisions.

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Legislation in the form of the *Securities Litigation Uniform Standards Bill 1997* was proposed to deal with this result by providing that the federal rules will prevail, but this legislation has not been passed.

See also analysis in R. A. Rosen "The Statutory Safe Harbour For Forward Looking Statements After Two and a Half Years: Has it Changed the Law? Has it Achieved What Congress Intended?" (1998) 76 Wash Uni LQ 645.

<sup>221</sup> In 1992 copycat legislative changes to the United States were proposed for Canada by the Allen Report - Committee on Corporate Disclosure "Responsible Corporate Disclosure, Final Report" (1997, Toronto Stock Exchange).

<sup>222</sup> In *Schneider* (1972) it was famously put that (at 266):

"reading a prospectus without soft information is like watching a performance of Hamlet with the role of the prince unfilled. In either case, the viewer may get some interesting tidbits of background information, but very little idea of what the real story is about".

<sup>223</sup> See *Pancontinental Mining Ltd v Goldfields Ltd* at 475 and *Soloman Pacific Resources NL v Acacia Resources Ltd* at 242.

<sup>224</sup> For example through forward looking M, D&A.

The outcome of the *Goldfields* case is a perception that reasonable investors require a financial forecast. On this basis, it is suggested that will be a reasonable expectation for the inclusion of this type of information in most prospectus and scrip takeover cases.<sup>225</sup> That general view has been perpetuated by the Takeovers Panel. It has been argued that the resolution of the fact sensitive inquiry as to whether financial forecasts are required will be resolved by the need to lead evidence as to the informational requirements of investors and their advisers and, critically, comparable prospectuses that have recently been issued.<sup>226</sup> The difficulty with this approach is that if the question is asked - are forecasts of value - the answer will be a clear and unresounding “yes”.<sup>227</sup> That being said, the impact of soft information on the investment process is elusive in that such information does not offer the certainty of factual information. The theoretical policy underpinnings of information efficiency should reflect that reality.<sup>228</sup> In addition, blind reliance by unsophisticated investors on that information is open to question.<sup>229</sup> Concerns of irrationality in the investment process should not undermine that principle.<sup>230</sup>

On the other hand, in the *Solpac* case, McClelland J did not seem to approach the case from the needs or perceived desires of investors, but instead focused on the unreliability of forecasts and the potential to mislead. This approach clearly comes from the concerns of the liability cases canvassed above and the historic distinction between statements of fact and statements of

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<sup>225</sup> See for example *Note (Walker & Kriedemann)* supra at 48 and *Hirst, Law & Gallery* supra at 40-1.

As noted at the text accompanying footnote 27 above, the initial double test of reasonably “require” and reasonably “expect to find” has been changed to a test where reasonably “expect to find” qualifies the general test. This was expressed to ensure that historic disclosure is not used to determine the appropriate level of disclosure. The reasons for the change obviously undermine the approach to inquiries adopted in the *Goldfields* case. However, the likely semantics involved in the distinctions of the *CLERP Act* analysis is unlikely to change the general conclusions expressed in this section.

<sup>226</sup> See for example *Case Note (D. Nathanson)* supra at 530-1.

<sup>227</sup> It should be noted that for many established companies analysts forecasts will be available, (at least to institutional investors) that will be prepared following close analysis of the company (that would certainly have been the situation in the *GIO* case). Analyst forecasts tend to be more reliable than other potential sources of market information - see L. D. Brown & M. S. Rozeff “*The Superiority of Analysts’ Forecasts as Measures of Expectations: Evidence from Earnings*” (1978) 33 *Jnl of Fin* 7; E. J. Elton, J. J. Gruber & M. Gultekin “*Professional Expectations: Accuracy and Diagnosis of Errors*” (1984) 19 *Jnl of Fin & Quantitative Analysis* 351.

However management forecasting tend to be more accurate than analysts forecasts - *Herder (1991)*. Compare Ruland “*The Accuracy of Forecasts by Management and by Financial Analysts*” (1978) 53 *Accounting Rev* 439.

An interesting counter agreement could be mounted by reference to the survey undertaken by Chant Link & Associates in 1994 for ASIC in relation to the perceived needs of retail investors “*A Market Research Report for the Australian Securities Commission on Prospectuses Amongst Retail Investors and their Advisors*” (31 March 1994) where the general view of the 304 surveyed investors was that the value of forecast information was low because of perceived unreliability and only 3% of the sample suggested more detailed forecasts would be desirable (at 56 and 71). On the other hand surveyed brokers/advisors considered management comment on future performance to be a key information requirement (at 132).

<sup>228</sup> See text accompanying footnote 231 of Chapter 1.

<sup>229</sup> See Chant Link analysis in footnote 224 above.

<sup>230</sup> See the conclusions at text accompanying footnote 280 of Chapter 1.

intention as has now been reinforced in the cash bid takeover cases.<sup>231</sup> In expressing these views, the court is expressing a noble sentiment, but not addressing the needs of investors or the operation of the modern securities markets.<sup>232</sup>

The *GIO* case reflects a finer balance between the competing starting point of the *Goldfields* case and the *Solpac* case. It suggests that where an election is made to include a forecast, that will not be criticised provided the court is satisfied that there were reasonable grounds to believe the forecast was reliable. On the other hand, if a decision is made not to include a forecast on the basis of reliability concerns that decision will not be second guessed if made in good faith.<sup>233</sup>

The difficulty with the approach of the *GIO* case is that it does not provide clear guidance as to when a forecast will or will not be required. Instead the focus is on when the decision that is made by the preparer will be susceptible of challenge and is susceptible of ex post facto rationalisation to justify desired outcomes.<sup>234</sup> The concept of reliability is clearly an imprecise term where many views can be held. As such the test leads to indeterminacy.<sup>235</sup>

This author would argue that what is required to satisfy obligations of disclosure under the section 710 standard of disclosure is for a different approach to be adopted. That approach would look to the needs of investors as reflected by the information that has actually been disseminated in the marketplace. Ultimately, a disclosure document reflects a bargaining process between various interested constituencies - the issuer of the securities, the brokers and the investing

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<sup>231</sup> As noted above, following the *CLERP Act* the obligation to disclose other "material information" in the scrip offer context explicitly does not extend to information relating to the value of the securities offered - see footnote 141 above.

<sup>232</sup> A United States commentator (discussing the "bespeaks caution" doctrine) has noted that judges adopting such an approach may invoke the false consensus of a judges approach to disclosure without reflecting the actual behavior of the population at large ("In real life, optimism sells") - *Langevoort (1994)* at 493 - 4.

To similar effect, in *V. Brudney "A Note on Materiality and Soft Information Under the Federal Securities Laws"* (1989) 75 Va L Rev 723 it is suggested that the task of deciding whether information is subject to mandatory disclosure is not easily separable from judgements about the kinds of information that should be required to be disclosed, which depends upon judgements of materiality (at 728).

<sup>233</sup> And perhaps for example that the preparer was not withholding information that would have a significant influence on investors.

The results of the Takeover Panel decisions also reflect such an approach.

<sup>234</sup> This was the very criticism made by *GIO* in the *GIO* case but rejected by Emmett J - see *GIO* case at 624.

<sup>235</sup> Similarly the question of the time period of any forecast that is given is indeterminant based on the above case law. The required time period has varied from two years to less than two months.

The term of the forecast is not as significant an issue from the policy perspective as the question of inclusion of a forecast. Clearly the longer the forecast period the greater the uncertainty and the less reliable the information. Other factors will also bear on reliability from issuer to issuer (as is illustrated by the special considerations that apply to insurance companies discussed in the *GIO* case). As was noted in the *Goldfields* case a discounted cash flow valuation should not be required because of the long forecast period that would need to underpin that methodology - see also *Note (Walker & Kriederman)* above at 50.

public. It is no mistake that the only Australian prospectuses to date that have not disclosed a financial forecast are those prospectuses where the issuer has had the bargaining power to resist the inclusion of such materials in its prospectus but commercially has nevertheless been able to proceed with the offering.

On this basis, the concern of the court would not be to ensure that a financial forecast was not included in the prospectus, but instead to ensure that all investors have equally access to the information that was released as part of the offering. Therefore if, for example, the issuer had selectively released soft information such as a financial forecast to institutional investors but did not include it in the prospectus, the prospectus should be considered to be deficient as it has not included all information that the market ultimately bargained for release. In other words an investor and their professional advisors would “reasonably require” the release of information that is selective. If, on the other hand the prospectus contains all material soft information that has been released to any group of potential investors by or on the authority of the issuer in relation to the issuer’s prospects, then it should not be considered as deficient on the basis the facts have not demonstrated the investors and their professional advisors require the release of that information.

It was noted at the commencement of this chapter that the general disclosure standard is an example of a “mud rule” or “fuzzy law”. It has been suggested that judicial errors in the administration of fuzzy laws result in great pressure to change back to more specific rules or to create safe harbours for liability purposes.<sup>236</sup> The case law on prospects is a classic illustration of this type of dilemma.

### **Relevance of Analysis to the General Disclosure Standard**

This section has sought to demonstrate the indeterminacy of the Australian disclosure regime as it applies to prospectus disclosure. The test similarly involves indeterminacy in relation to other aspects of disclosure of the financial position of the issuer of securities. For example, what period of time must the historical accounts disclosed by the issuer cover or how recent must the most recent audited accounts be (an issue previously prescriptively set out in the predecessor Australian legislation and prescriptively set out in the comparable US and UK disclosure regimes).

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<sup>236</sup> See the analysis in *Whincop (1999)* at 21.

It should be recognised that the areas of soft information poses special issues in terms of the disclosure test and the applicable liability regime, as has been outlined above. However, the issue of indeterminacy remains a key challenge with the Australian regime.

Ultimately for a small capital market like Australia, indeterminacy involves the potentiality of higher costs of fundraising because of the lack of clarity as to the scope of the provisions and lack of likely judicial guidance. The tinkering with the standard of “reasonably expect to find” in the *CLERP Act*<sup>237</sup> is unlikely to change that result because it deals with an indeterminant concept itself.

On the other hand, if the prospectus provisions are not properly enforced (either by ASIC or through the courts), indeterminacy involves the risk of inadequate disclosure as issuers run the calculated risk of failing to meet minimum disclosure expectations in the absence of clear guidelines that confirm general market expectations.

The *CLERP Act* materials have noted that the checklist approach to disclosure had advantages of lower compliance costs while the general test offers advantages of flexibility. Without wishing to re-enter the entire mandatory disclosure debate as outlined in Section 1.6, the case study in this Section demonstrates that there may be some merit in introducing some minimum disclosure requirements in aid of the general test so as to introduce greater certainty to the Australian market.

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<sup>237</sup> See text at footnote 27.

## CHAPTER 7

### CORPORATE INSIDER LIABILITY

The following three chapters involve a practical analysis of the operation of the *Corporations Act* prospectus liability provisions by reference to the three broad categories of persons who face potential liability for a prospectus misstatement: the issuer and corporate insiders, underwriters and sharebrokers and professional advisors.

The enactment of the *Corporations Law* involved no radical change of policy in imposing potential liability on the directors of the issuer for prospectus misstatement. In addition, no fundamental shift in the application of the liability and defence provisions as they relate to directors would appear to have been contemplated.

However, the general perception of the business community at the time of enactment of the *Corporations Law* was that the position of directors, in particular, had been targeted by the legislation so that greater responsibility and care was imposed on them in relation to the capital raising process.

Against that background this chapter considers the liability position of directors under the Australian regime.<sup>1</sup> That position is then contrasted with the position faced by the issuer itself and the position of management under the *Corporations Act* provisions.

#### 7.1 SUMMARY OF THE REGULATORY PROVISIONS

##### *Corporations Act*

In contrast to the confusing regulatory regime that applied before the enactment of the *CLERP Act*,<sup>2</sup> the application of the *Corporations Act* to directors is now relatively straightforward.

The director does not confront potential primary criminal liability for a disclosure document because the only person with primary liability is the person offering the securities.<sup>3</sup> However the

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<sup>1</sup> Many of the issues addressed in this chapter are also dealt with in the *Golding (1997)* articles (based on the pre-*CLERP Act* position).

<sup>2</sup> For discussion of the predecessor provisions under the *Corporations Law* see *Golding (1997)* at 178-186.

<sup>3</sup> See analysis at text accompanying footnote 39 of Chapter 2.

director may face potential criminal liability as an accessory. Each director of the issuer is expressly made liable for the disclosures in the disclosure document for purposes of potential civil liability.<sup>4</sup> In addition, a person named in the disclosure document with their consent as a proposed director is placed in the same position.<sup>5</sup> The due diligence defences and reasonable reliance defences of CA section 731 and section 733 are available to the director. In addition a named proposed director can rely upon a withdrawal of consent defence if the consent is publicly withdrawn.<sup>6</sup> It should be noted that these defences are available to the director not only for civil liability but also potential criminal liability as an accessory.<sup>7</sup>

On the other hand, management of the issuer are not specifically expressed to face potential primary criminal or civil liability for a disclosure document.<sup>8</sup> They do, however, face potential criminal and civil accessory liability.

Finally, the issuer or seller of the offered securities faces both primary potential criminal<sup>9</sup> and civil liability<sup>10</sup> for the disclosure document. The issuer has available to it the due diligence and reasonable reliance defences of CA section 731 and section 733. However the reasonable reliance defence must relate to reliance on someone other than a director, employee or agent of the issuer or seller.<sup>11</sup>

This should be contrasted with the position under the pre-CLERP CL where the director was generally considered to have potential primary criminal liability as a person who authorised or caused the issue of a prospectus - see *Golding (1997)* at 179-180. See also the discussion at Section 2.1 above.

<sup>4</sup> Section 729(1), Item 2.

<sup>5</sup> Section 729(1), Item 3.

<sup>6</sup> CA section 733(3). There is limited case law on the withdrawal of consent defence.

In *Drincqbier v Wood* [1899] 1 Ch 393 an attempted withdrawal of consent under the *1890 Directors Liability Act* was held to be too late when the withdrawal occurred after the litigation had commenced (Byrne J at 406).

In *Hoole v Speak* [1904] 2 Ch 732 a director was held not liable under the *1890 Directors Liability Act* and the *1867 Material Contracts Act* where a prospectus was issued without the consent of the director. Such a situation could not occur under the *Corporations Act* in view of the requirement that all directors must consent to the disclosure document - section 720 of the CA.

<sup>7</sup> This arises because each defence states the person “does not commit an offence against subsection 728(3), and is not liable under section 729 for a contravention against subsection 728(1), because” [of the misstatement]. It would therefore seem to follow that the derivative offence or liability under section 5 of the *Crimes Act* would similarly not arise.

This feature acts to generally modify to operation of accessory liability as it applies to the prospectus liability provisions.

<sup>8</sup> In some cases it might be argued a member of management might face primary civil liability for a statement in acting as a de-facto director or assuming responsibility for a statement - see Section 7.4.

<sup>9</sup> CA section 728(1) and (3).

<sup>10</sup> CA section 729(1), Item 1.

<sup>11</sup> Section 733(1)(a). If the seller is an individual someone other than an employee or agent - section 733(1)(b).

### A Comparison with United States

There is a high level of similarity between the insiders facing responsibility under the liability and defence regime applicable between the Australian and United States regime.

Under Section 11 of the *Securities Act* 1933, every director, proposed director and person who signs a registration statement faces liability for a misstatement contained in a registration statement.<sup>12</sup> A director or proposed director has available withdrawal of consent defences,<sup>13</sup> traditional due diligence defences and expertisation defences.

Under section 12(2) of the *Securities Act*, the director will also face potential liability as a person offering or selling a securities because the director is responsible for the dissemination of the prospectus. Under section 12(2) the director will have the reasonable care due diligence defence of that section.

In relation to management, the United States approach is to require that senior members of management also sign the registration statement and accept statutory liability for its contents.<sup>14</sup> The treatment of management therefore differs for Australia.

There is no defence for liability available to the issuer in the United States.<sup>15</sup> The issuer is absolutely liable for the prospectus and has no due diligence defence.

Canada generally follows the United States approach to liability.

### A Comparison with United Kingdom and other Commonwealth Jurisdictions

Under the *Financial Services and Markets Act 2000* and *The Public Offers of Securities Regulations 1995* every director and person who is named as having agreed to become a director

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<sup>12</sup> See Section 11(a)(1), (2), (3) of the *Securities Act* 1933.

<sup>13</sup> The withdrawal of consent defences apply in the following circumstances:

- where the registration statement has not become effective, they have resigned or have ceased or refused to act and advised the Securities Exchange Commission in writing of that (section 11(b)(1)); or
- if the registration statement became effective without their knowledge, they forthwith act and advise the SEC of becoming aware and in addition, gives reasonable public notice that the registration statement had become effective without their knowledge (section 11(b)(2)).

Withdrawal is not contemplated in circumstances where a registration statement becomes effective with knowledge.

<sup>14</sup> Section 6(a) - these persons are the principal executive officer or officers, the principal financial officer, the comptroller or principal accounting officer.

<sup>15</sup> Section 11(b) provides “no person, other than the issuer, shall be liable [if certain defences are established]”.

faces liability for a misstatement contained in listing particulars or a prospectus.<sup>16</sup> A director or proposed director has available withdrawal of consent defences, traditional due diligence defences and expertisation defences. The defences are analogous to the *Corporations Act*. The issuer also faces potential liability as discussed in Section 7.5.

Other Commonwealth countries typically follow this approach in relation to directors.

## 7.2 CASE LAW PRECEDENT ON DIRECTORS

### Australian/Commonwealth Material

It is a common misapprehension in Australia that there is no useful case law on the position of the director under the *Corporations Act* regime of liability for prospectus misstatement. While the body of case law is not substantial, it does provide a very clear indication of the judicial approach that is likely to be adopted when the prospectus liability due diligence defences come to be considered under the *Corporations Act*.

A series of English cases from early this century clearly illustrate the issues that contemporary courts are likely to grapple with in addressing the position of a director. Indeed, the basic contours of the analysis can readily be garnered from a review of three cases decided in 1904.

In *J.P. Coats v Crossland*<sup>17</sup> a director failed in an attempt to rely on the due diligence defence under the *1890 Directors Liability Act*.<sup>18</sup> The case involved a prospectus misstatement arising from non-disclosure of the terms of acquisition of an asset from the promoter of the issuer. The non-executive director defendant had relied on a verbal assurance from the promoter that the disclosure in the prospectus of the acquisition was adequate for the purposes of the disclosure laws. The court had no difficulty in reaching the view that accepting such an assurance would not constitute the satisfaction of a due diligence defence.<sup>19</sup> The case clearly demonstrates that blind acceptance of assurances as to disclosure given by a self-interested party will not be acceptable.

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<sup>16</sup> Paragraph 6(1)(b) and (c) of the *Financial Services and Markets Act 2000 (Official Listing of Securities) Regulations 2001* and Section 13(1)(b) and (c) of *The Public Offers of Securities Regulations 1995*.

<sup>17</sup> *J. and P. Coats Limited & Ors v Crossland & Ors* (1904) 20 TLR 800 (Swinton Eady J).

<sup>18</sup> In addition liability in deceit and under the *1867 Material Contracts Act* was established.

<sup>19</sup> *Ibid* at 806.

On the other hand, in *Stevens v Hoare*<sup>20</sup> a director succeeded in relying on the due diligence defence under the *1890 Directors Liability Act*. In that case the non-executive director defendant had given evidence that he believed in the truth of the statements made in the prospectus. The grounds for that belief were inquiries made by the director of the legal advisors to the issuer and management of the issuer. The key issue was whether the director was entitled to rely on the inquiries conducted by those persons and the reports of those inquiries made to the director. The reliance was considered justified.<sup>21</sup>

The practical realities of the position faced by a non-executive director in needing to rely on the advice and work of the company's officers and agents rather than do the work himself was clearly recognised in the case.<sup>22</sup>

However, the danger for a non-executive director in blindly relying on the advice of an advisor is demonstrated by the 1904 House of Lords decision in *Shepherd v Broome*.<sup>23</sup> In that case the directors of the issuer were aware of the existence of a promoter's contract that was not disclosed in the prospectus.<sup>24</sup> The defendant director had taken legal advice that disclosure of the contract was not required by the legislation. The trial judge found that the director had acted honestly and

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<sup>20</sup> *Stevens v Hoare* (1904) 20 TLR 407. The case again involved an alleged omission to disclose the terms and conditions on which certain assets were to be acquired from the promoter of the company.

<sup>21</sup> *Id* at 409.

"Had he reasonable ground for believing the statements in question to be true? It cannot be, and has not been, said that he had no ground for so believing. But the case has been argued on the part of the plaintiff as if the statute had required of a director not merely reasonable, but sufficient, grounds for his belief. Indeed, it was rather suggested that a director is not entitled to rely upon the assistance or advice of solicitors or clerks, but that with his own hands and eyes he must search out and read every relevant document, and with his own mind judge of its operation and legal effect, and that he could not depose to of his own knowledge in a Court of justice. If so he would be bound to do a great deal more than the most industrious and prudent man of business could think of doing, or in most cases would be able to do, in the conduct of his own affairs.... I am of opinion that the defendant had reasonable grounds for believing the statements of the prospectus to be true."

It should be noted that these statements were largely obiter dictum as Joyce J did not appear to consider an actionable misstatement had arisen.

The decision of the court clearly reflects scepticism as to the plaintiff's claim on a number of grounds. Joyce J does not identify with any precision how the defendant's reliance on advisors and management was relevant to the misstatement in question. The *Stevens v Hoare* case can be therefore criticised for the general and non-specific way in which the plaintiff's claims were rejected by Joyce J.

<sup>22</sup> In addition the plaintiff failed to establish reliance or that the losses were caused by the alleged misrepresentation. It was held that the financial failure of the company 3½ years after the date of the prospectus was not caused by any misrepresentation in the prospectus. *Id* at 408.

For criticism of this issue in determining damages see text at footnote 153 of Chapter 3.

<sup>23</sup> *Shepherd & Anor v Broome* [1904] AC 342 (affirming Court of Appeal and trial judge (Buckley J) in *Broome v Speak* [1903] 1 Ch 586).

<sup>24</sup> The contract in question related to a substantial fee paid to a promoter of the issuer in relation to assets acquired by the issuer - see [1903] 1 Ch 598-600 (Buckley J).

believed that the contract was not material.<sup>25</sup> However the finding of the House of Lords was that where a director has knowledge of an omitted matter that should have been disclosed in the prospectus the due diligence defence under the *1890 Directors Liability Act* is not available, even where the director was acting in good faith and with no intention to mislead. A mistake of law when the relevant facts are known was not considered to constitute reasonable belief in the truth of the relevant statements.<sup>26</sup>

These three cases<sup>27</sup> clearly flag the key issues that will arise in most circumstances where a non-executive director seeks to rely on the due diligence defence for a prospectus misstatement. First, the standard of conduct required of a director. Second, a recognition of the practical necessity that a non-executive director will delegate certain of the tasks involved in prospectus preparation. Third, the extent to which the director will be entitled to rely on assurances given by officers and advisers as to the disclosures in a prospectus.

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<sup>25</sup> See Buckley J [1903] 1 Ch 603.

<sup>26</sup> “It is contended for the appellant that he is not liable under this Act because he had reasonable ground to believe, and did believe, that the statement in the prospectus was true. But he knew they were not disclosed; he thought they were not such as required disclosure. This is a question of law, and I agree with Buckley J and the Court of Appeal that a mistake of this kind does not furnish a defence to an action founded on the statute in question.”

Ibid at 347 (Lord Lindley). To similar effect see Lord James at 346.

See also Buckley J [1903] 1 Ch 603:

“He did attempt to protect himself in this way - that he went to counsel, and counsel said the prospectus could be issued as it was, and that, having regard to the rescission of the contract, it would do. But counsel cannot protect directors by telling them that they not comply with an Act of Parliament if they ought to comply with it. The question is simply one of fact, whether it existed or not, if the contract did exist, then the statute applied.”

See also Court of Appeal at 618-9 (Collins MR), 628 (Romer LJ). *Shepherd v Broome* can clearly be categorised as a “hard” case in that non-disclosure of promoter contracts was an evil long identified as a regulatory difficulty in the prospectus context - the problem was after all the genesis of the *1867 Material Contracts Act*.

In addition, the omission constituted a contravention of the *1867 Material Contracts Act*. Only Lord Lindley and Lord James considered directly the due diligence defence of the *1890 Directors Liability Act*. Similarly the Court of Appeal did not consider it necessary to refer to the *1890 Directors Liability Act* because of the contravention of the *1867 Material Contracts Act* - see [1903] 1 Ch 623 (Collins MR).

<sup>27</sup> A further 1904 case under the *1890 Directors Liability Act* was *De La Cour v Clinton-Trechman v Calthorpe* (1904) 20 TLR 420 (Joyce J) and 706 (Court of Appeal). In that case two non-executive directors successfully relied on the due diligence defence in the *1890 Directors Liability Act* (although ultimately they were held liable for an omission under the *1867 Material Contracts Act*). The trial judge found, based on the evidence and witness testimony, that the directors had reasonable grounds to believe the prospectus statements (see at 422 - see also Vaughan Williams LJ at 710). The case report does not disclose the judge’s basis for that conclusion. As such, the case is of little assistance.

Further cases from that period involving liability under the *1890 Directors Liability Act* without useful analysis for purposes of this dissertation includes *Drinquier v Wood* [1899] 1 Ch 393 (director abstaining from inquiry as to prospectus has no defence (Byrne J at 404)); *Greenwood v Leather Shod Wheel Company* [1900] 1 Ch 421 (no care taken to ensure prospectus was not misleading (Lindley MR at 434)).

All three issues came together in the most significant early English case on the due diligence defence, the 1915 decision of *Adams v Thrift*.<sup>28</sup> It is useful to review this case for the lessons it will provide contemporary directors.

The prospectus in *Adams v Thrift* contained a number of serious misstatements concerning the business of the issuer.<sup>29</sup> Each of the four non-executive director defendants failed to establish the due diligence defence of the *1890 Directors Liability Act*. While none of the directors was found to be guilty of fraud or deceit,<sup>30</sup> the trial judge was not satisfied that three of the non-executive directors had established to his satisfaction that they believed the prospectus statements to be true (the legislation, like CA section 731, requiring as a precondition to the availability of the due diligence defence that the defendant did “believe, that the statement was true”).

The reasons for this finding are instructive. One director had admitted he had not read the prospectus before signing it,<sup>31</sup> one director was a poor witness and gave contradictory evidence as to his belief in the truth of the statements,<sup>32</sup> while one director was too ill to give any evidence to establish that he believed in the truth of the statements.<sup>33</sup> As such, the case is authority for the proposition that a director must take positive steps to familiarise himself with the disclosures in a prospectus (and be able to present evidence of that at trial) before the court will infer that the director believed in the truth of the statements in question.<sup>34</sup>

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<sup>28</sup> *Adams v Thrift* [1915] 1 Ch 557. The decision in relation to one of the directors (Dr Clarke) affirmed by Court of Appeal in *Adams v Thrift* [1915] 2 Ch 21.

The case was a civil action brought under section 84 of the *Companies (Consolidation) Act 1908* (England) which was largely identical to the *1890 Directors Liability Act*.

<sup>29</sup> The misstatements included (1) misstatement that the business was protected by patents (when it was not) (2) misstatement that the business had been highly profitable (when it was not) (3) misstatement as to turnover of the business (4) misstatement as to the number of branches and agencies of the business. *Ibid* 1 Ch at 564.

The misstatements were the responsibility of the managing director and promoter (Mr Holt) who was described as an “unscrupulous individual who, in accordance with long-established precedent, is conspicuously absent when the tale of his rascality is told” - *Ibid* 1 Ch at 561.

<sup>30</sup> *Ibid* 1 Ch at 562.

<sup>31</sup> (Dr Clarke) *Ibid* 1 Ch at 562-3 “I feel it impossible to hold that a man can have believed statements to be true when at the same time he admits he had no knowledge what the statements were.”

<sup>32</sup> (Mr Buddicom) *Ibid* at 563. In addition the trial judge suspected a relationship between this director and the promoter - see below.

<sup>33</sup> (Lord Rosmead) *Ibid* 1 Ch at 563.

Further authority for the proposition that a defendant director must adduce evidence as to the basis of his belief is *Alman v Oppert* [1901] 2 KB 576 (directors required to deliver particulars as to basis of belief in pleading the due diligence defence under the *1890 Directors Liability Act*). Compare *Weinberger v Inglis* (1918) 1 Ch 13.

<sup>34</sup> On the other hand the fourth director did establish to the court’s satisfaction that he believed in the truth of the statements at all relevant times (Sir John Thrift).

While the failure to establish belief in the truth of the statements in question disposed of the case of three of the four directors the trial judge went on to consider generally the availability of the “reasonable grounds of belief” element of the due diligence defence. Eve J said this issue involves consideration of five issues:

“first, the untrue statements; secondly, the subject-matter in relation to which they were made; thirdly, the facility or difficulty of testing the truth of each statement; and, fourthly, what steps, if any, the defendants collectively took to make the test, and as affecting each defendant; fifthly, what steps, if any, he individually took, and on what grounds he based his belief.”<sup>35</sup>

As to the first three issues, concerning the nature of the misstatement and the practical possibility of verifying the statement, the trial judge considered that the misstatements in the case involved simple statements of fact that could have been tested directly by the director himself or by retaining an appropriate advisor.<sup>36</sup>

As to the fourth criteria, group inquiry by the board, no evidence was presented that the board formally called for any verification or advice on the prospectus or authorised any investigation of the disclosures in the prospectus. Eve J accepted that the due diligence defence could have been satisfied through appropriate group inquiry. The inquiry that should be undertaken was considered to be that required to satisfy a “reasonable man” that the statement were true on the basis of reasonable inquiries conducted by independent agents.<sup>37</sup>

However, as noted above, the board had undertaken no inquiries whatsoever as to the disclosure contained in the prospectus.<sup>38</sup> In the absence of group inquiry the establishment of the due

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<sup>35</sup> Ibid 1 Ch at 563-4.

<sup>36</sup> The misstatements related to existing assets. Eve J suggested a lawyer or patent attorney could have been retained in relation to the patents or an accountant could have been retained in relation to profits, turnover and branches. Ibid 1 Ch at 564-5. “I cannot conceive a case in which the necessity for verification could be more apparent, or the means of obtaining it more obvious.”

<sup>37</sup> Ibid 1 Ch at 565.

“Counsel for one of the defendants contended that the arguments advanced on behalf of the plaintiff involved this consequence, that no director could discharge the onus of proving that he had reasonable ground for believing a statement to be true without showing that he had separate advice from his own lawyer, his own accountant, and, may be, from his own patent agent. I do not agree. In my opinion the existence of a reasonable ground for belief in the truth of any statement is established by the proof of any facts or circumstances which would induce the belief in the mind of a reasonable man, that is to say, a man who stands midway between the careless and easy-going man on the one hand and the over-cautious and straw-splitting man on the other. Who will deny that such a man might reasonably believe in the truth of statements verified by competent and independent agents, instructed not by him individually, but by or on behalf of a board of directors of whom he was one?”

<sup>38</sup> “Unfortunately, the defendants collectively did nothing. On the evidence, as it stands, no inquiries were made, no proofs were called for, no questions were asked, no advice was taken, and no investigation whatever was made by the board. As a board they seem to have treated the settling and approving of the prospectus, prepared and put before them by the man whose interest it was to exaggerate and inflate the value of everything the company was about to acquire, as a mere formality.”

(Ibid 1 Ch at 565)

diligence defence depended entirely on the due diligence inquiries individually undertaken by each director.

One director had agreed to join the board of the issuer approximately three months before the prospectus was prepared. Before joining the board he had consulted with his solicitor, who retained accountants to give advice on the business of the issuer. His solicitor ultimately reported back to the director that the business of the issuer “is quite satisfactory” and “it is evidently a good thing”<sup>39</sup> and on that basis he joined the board. These general inquiries were argued to constitute reasonable grounds of belief for purposes of the prospectus. That argument was rejected on the basis that the inquiries provided no evidence of reasonable grounds for belief in relation to specific statements in a prospectus that did not come into existence until some months later.<sup>40</sup>

Two other directors argued that the due diligence defence would be satisfied by uncorroborated statements they had received from the promoter concerning the business of the issuer in response to inquiries they had made of the promoter. It was considered that such statements:

“ought to and do afford very good ground for exciting doubt and mistrust, where for example they are of a flamboyant and exaggerated character”<sup>41</sup>

rather than establishing the due diligence defence.<sup>42</sup>

Of those two directors, one director also argued that he was aware that another director (see below) had only signed the prospectus after undertaking extensive inquiries in relation to the statements in the prospectus. Reliance on that fact, without an understanding of the nature of the

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<sup>39</sup> Ibid 1 Ch at 566.

<sup>40</sup> Ibid 1 Ch at 567:

“It only shows that Lord Rosmead was cautious before accepting the directorate, and that he did not lend his name to this concern without obtaining some evidence that it was a respectable concern; but it affords, in my opinion, no evidence to prove that Lord Rosmead ever had any reasonable grounds for believing statements which did not come into existence for months afterwards to be true.”

<sup>41</sup> Ibid 1 Ch at 567. Predictably the promoter had become a bankrupt - see [1915] 2 Ch 21. “I cannot conceive any reasonable man accepting the mere statement of the vendor that his business had returned a profit of 50 per cent as sufficient proof of the fact to enable him to say he believed it to be a fact.”

The case is therefore consistent with *J.P. Coats v Crossland* discussed above.

<sup>42</sup> One of the directors (Mr Buddicom) was also considered to have a close association with the promoter that suggested a lack of “frankness”. Ibid 1 Ch at 569. Buddicom also relied on a letter from the promoter which Eve J suggested may have been a self serving device designed to protect Buddicom in the litigation.

inquiries (or without having personally read the prospectus) was not considered to form a proper basis for establishing the due diligence defence.<sup>43</sup>

One of these directors appealed. The Court of Appeal dismissed the appeal, again confirming that reliance on confirmations received from the promoter would not constitute appropriate due diligence,<sup>44</sup> nor would reliance on inquiries conducted by another director where the director had no knowledge of what those inquiries entailed.<sup>45</sup>

The final director had established to the satisfaction of the trial judge that he believed the prospectus statements to be true. In addition he had exercised far greater diligence in reviewing the disclosures in the prospectus than the other members of the board. He frequently attended the premises of the issuer to observe its business and he reviewed certain correspondence relevant to statements contained in the prospectus. However there was also an accumulation of matters that the trial judge considered should have put him on notice of inquiry or to have created an atmosphere of suspicion.<sup>46</sup> In conclusion his approach to the inquiries he had undertaken was summarised as “an attitude of almost childlike credulity” and:

“Unfortunately he accepted the statements of a rogue, and when he made any attempts to investigate them he allowed himself to be put off by these miserably unsatisfactory excuses.”<sup>47</sup>

The due diligence defence was therefore not established.

Clearly *Adams v Thrift* provides a useful morality tale for modern directors as to what is required to establish the due diligence defence. The case demonstrates the danger on relying on self-interested directors and management, the need to have considered carefully the statements contained in the prospectus and the need to follow up matters that suggest suspicion. On the other hand group inquiry and appropriate reliance on agents was specifically mandated as an appropriate way in which to approach prospectus inquiries.

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<sup>43</sup> Ibid 1 Ch at 568.

<sup>44</sup> Ibid 2 Ch at 24 “the promoter is the very last person whose uncorroborated statements ought to be relied upon by an intending director as justification for saying he had reasonable ground for belief” (Lord Cozens Hardy MR).

<sup>45</sup> Ibid 2 Ch at 24 (Lord Cozens Hardy), 25 (Pickford LJ) and 26 (Warrington LJ). Lord Cozens Hardy said the appeal was “hopeless”.

<sup>46</sup> Those matters were that he had asked for the company’s books of accounts on many occasions and encountered only excuses. He then asked for annual accounts and was told there were none! (The business had been operating for 4 years.) Sir John Thrift also uncovered a tax avoidance structure used by the promoter which should have suggested to Thrift the promoter had “an elasticity of conscience”.

<sup>47</sup> Ibid 1 Ch at 571.

After this early rush of litigation the due diligence defence seems to have withered as a subject of case law. In the period following *Adams v Thrift*, while having become pivotal to the enforcement mechanisms of the prospectus laws in Commonwealth countries, the scope of the directors' due diligence defence has not been the subject of further detailed judicial analysis.<sup>48</sup>

### United States Material

The seminal authority in any jurisdiction on the practical requirements for the establishment of a due diligence defence remains the 1968 Southern District New York opinion of Judge McLean in *Escott v BarChris Construction Corporation*. For that reason it is helpful to analyse closely the way in which the court applied the facts to the position of a director. It is also interesting to contrast that decision with *Adams v Thrift*, as clearly the facts as to the inquiries undertaken and the results of the two cases are very similar.<sup>49</sup> The cases should be seen as complimentary and illustrative of the common approach reflected by Commonwealth and United States law.

In the *BarChris Case* all of the directors of an issuer were found liable under section 11 of the *Securities Act* for prospectus misstatements, as well as the issuer, the underwriting syndicate responsible for the securities offering and the auditor responsible for certifying the financial statements in the registration statement.

The court had no difficulty in establishing that the prospectus and registration statement contained various misstatements and that those misstatements were material.<sup>50</sup> As a consequence, the issuer had strict liability for the misstatements while the directors, underwriter and auditor had presumptive liability unless they could establish the due diligence defences.

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<sup>48</sup> An exception is *Bundle v Davies & Ors* [1932] NZLR 1097 where reliance on the uncorroborated statements of one director was rejected as providing the basis of a director's due diligence defence for prospectus misstatement - *Adams v Thrift* was cited by Myers CJ of the New Zealand Supreme Court as authority for this proposition.

<sup>49</sup> For the same observation see J.G. Meeker "The Outside Director-Advice to My Client" (1969) Bus Law 573 at 582-3.

<sup>50</sup> The issuer was involved in the business of constructing bowling alleys. In May 1961 it filed a registration statement offering for subscription convertible debentures. In October 1962 the issuer filed for insolvency protection.

The misstatements included (1) the overstatement of income and assets, (2) the understatement of contingent liabilities, (3) failure to disclose that the proceeds of the issue were to be used to repay debt and not to fund expansion as had been disclosed, (4) failure to disclose that the deteriorating credit position of customers might require the issuer to repurchase factored debts and (5) failure to disclose that the issuer was operating bowling alleys as a result of customer defaults (a much riskier business than constructing bowling alleys). The misstatements are summarised in the *BarChris Case* at 679-80.

The securities offering also took place at a time when the bowling alley industry had reached the end of a speculative surge and had entered recession. In the bowling alley industry the issuer was a relatively small player with two other companies dominating the industry. (*BarChris Case* at 653-4. The issuer installed 3% of lanes while the remaining 97% of the market was shared largely by two other companies). In other words the issuer faced significant economic and general business risk. That risk was not disclosed in the registration statement.

Of the nine directors of the issuer, five were executives and four were non-executives. Of the four non-executives, one was an investment banker who was a partner of the lead underwriter, one was a lawyer who was a partner of the issuer's lawyer, one was a banker with the issuer's bank and the other had engineering qualifications. In addition to these persons, a non-director executive of the issuer (the company secretary) had signed the registration statement and faced section 11 liability.

An initial distinction was made between those parts of the registration statement prepared by an expert and those parts not prepared by an expert. As has been noted, section 11 of the *Securities Act* distinguishes for purposes of the due diligence defence between expertised parts of the prospectus and the non-expertised parts of the prospectus. An argument was presented in the *BarChris Case* that as the entire registration statements had been prepared by lawyers and accountants, the entire document was expertised for purposes of the operation of section 11. That argument was rejected.<sup>51</sup> The only parts of the registration statement that were considered to have been expertised were the financial statements that had been audited and certified by the accountants. In particular, the financial period from the end of the last audit period to the date of the registration statement (the so called "stub period") was not considered to have been expertised by the auditor.<sup>52</sup>

Each of the five executive directors failed to establish the due diligence defence in relation to the non-expertised parts of the registration statement. In addition four of the five executive directors (all except the company secretary<sup>53</sup>) failed to establish the due diligence defence in relation to the expertised parts of the registration statement.

The most significant lesson that comes out of the case is a much heavier burden imposed upon executive directors as compared with non-executive directors in establishing the due diligence defence. Certain basic propositions can be drawn from the case in assessing the position of executive directors.

First, the case demonstrates that regard should be had to the responsibility of the executive within the organization. For example the chief executive officer was "familiar with all aspects of the

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<sup>51</sup> *BarChris Case* at 683. "To say that the entire registration statement is expertised because some lawyer prepared it would be an unreasonable construction of the statute."

<sup>52</sup> *BarChris Case* at 683-4.

<sup>53</sup> All executive directors were members of the executive committee that was responsible for general management of the issuer.

business” and “knew all the relevant facts” relating to the misstatements.<sup>54</sup> In those circumstances, Judge McLean was not prepared to believe that such an executive would not have had knowledge of the misstatements in the prospectus.<sup>55</sup>

Second, regard was had to the actual skills of the executive directors in assessing their ability to establish the due diligence defence. For example, the chief financial officer of the issuer, a qualified accountant, was found by Judge McLean to be “intelligent” and familiar with corporate issues.<sup>56</sup> The availability of the due diligence defence for such a person was held to be subject to assessment on that basis.<sup>57</sup>

Third, regard was had to the actual role performed by the executive directors in relation to the preparation of the prospectus. For example, in the case of the chief financial officer it was found that he had not taken a proactive role in ensuring all information was provided to the professional advisors responsible for the preparation of the prospectus. The director had argued that he had relied on his professional advisors to tell him what was required for inclusion in the prospectus, suggesting if the advisors did not ask the right questions that was not his responsibility. Judge McLean rejected the suggestion such reliance was reasonable for purposes of the due diligence defence.<sup>58</sup>

The four non-executive directors fared slightly better than the executive directors, although no director managed to establish the due diligence defence in relation to all misstatements. A number of issues come out of the way in which the court approached the position of the non-executive directors.

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<sup>54</sup> *BarChris Case* at 684.

<sup>55</sup> On the other hand, the company secretary who was responsible for legal matters and did not participate in the management of the issuer (*Bar Chris Case* at 686) was entitled to rely on the due diligence defence in relation to the expertised portions of the registration statement, as he had no personal knowledge of the issuer’s financial statements. However again, the company secretary was not able to establish the due diligence defence in relation to non-expertised parts of the registration statement because he had not conducted any investigations in relation to the relevant statements in the prospectus and Judge McLean found that he had actual knowledge of certain of the misstatements. On this point it would seem that the *BarChris Case* suggests that if a prospectus misstatement involves a matter outside the responsibility of the executive and the executive makes some inquiry of those matters and is satisfied as to the accuracy of the disclosures, it will be possible for him to establish the due diligence defence in relation to that matter.

<sup>56</sup> *BarChris Case* at 685.

<sup>57</sup> By way of further illustration, the president and vice president of the issuer were found to be persons of “limited education” that would have difficulty with a prospectus (*Bar Chris Case* at 653 and 684). It was not clear that there was any qualification of the duty of inquiry having regard to this consideration. In any event, having regard to their responsibility within the issuer’s organization Judge McLean was not prepared to find that they had reasonable grounds for belief or actual belief in the truth of the statements in the expertised or non-expertised parts of the prospectus.

<sup>58</sup> *BarChris Case* at 685. It was held he could not “sit back and place the blame on the lawyers for not advising him about” the prospectus in these circumstances.

First, the burden of inquiry imposed upon the directors was considered to be dependant on the expertise and skills actually possessed by the director and their involvement in the affairs of the issuer. This point is best illustrated by reference to the position of the non-executive director who was a partner in the issuer's law firm and the non-executive director who was a partner with the lead underwriter, respectively.

The lawyer/director had been legal adviser to the issuer for some years and handled a number of capital raisings for the issuer.<sup>59</sup> As such:

“the unique position which he occupied cannot be disregarded. As the director most directly concerned with writing the registration statement and assuring its accuracy, more was expected in the way of reasonable investigation than could fairly be expected of a director who had no connection with this work.”<sup>60</sup>

While the lawyer/director had devoted a substantial amount of time to the preparation of the prospectus, it was held by the trial judge that the quality of that investigation was seriously lacking. Judge McLean rejected an argument that a lawyer in these circumstances is entitled to rely on statement of his clients without verification. However, it is important to appreciate that the judge was careful to stress that the lawyer had failed to check matters that could be easily verified through reference to source documents.<sup>61</sup> It was stressed that reasonable inquiries in these circumstances are a matter of degree and an audit is not required.

In the case of the director who was employed by the underwriter, the court imposed an underwriter's standard of inquiry.<sup>62</sup> The standard of inquiry imposed on the underwriter/director was analysed by Judge McLean on the same basis as the underwriter generally. The nature of that standard of inquiry imposes high standards of verification on the underwriter in dealing with information presented by management.

The second issue arising in relation to the non-executive directors is the need to conduct specific inquiries in relation to the prospectus disclosures. This point is illustrated by the remaining two

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<sup>59</sup> *BarChris Case* at 690.

<sup>60</sup> *BarChris Case* at 690. The position of the director in this case was compromised through his position as not only a person with legal expertise but also by being the issuer's legal adviser on the fundraising. In this situation it has been suggested “it is not unfair that he carry the heavy section 11 liabilities of directors while his due diligence defences reflect the standards applicable to the attorney-client relationship” - *Folk 1 (1969)* at 37.

<sup>61</sup> “The way to prevent mistakes is to test oral information by examining the original written record” (*BarChris Case* at 690). Judge McLean found that the director had not read any of the relevant financing documents that would have disclosed misstatements, did not review material contracts that would have raised concerns and did not insist that company minutes that were missing be prepared (*BarChris Case* at 690-2).

<sup>62</sup> See analysis in Section 8.3 below.

non-executive directors.<sup>63</sup> Both directors had only been appointed to the board of the issuer one month before the offering commenced.<sup>64</sup> One of the directors had been careful to review the business of the issuer before accepting the appointment as a director.<sup>65</sup> While these inquiries had been undertaken, the review undertaken by the directors of the disclosures in the registration statement itself was minimal at best. The court considered that such general and non-specific inquiries would not assist in the establishment of the due diligence defence. In that regard the *BarChris Case* is in complete conformity with *Adams v Thrift*.

The third issue arising in relation to the non-executive directors concerns inappropriate reliance on assurances of management. This point was demonstrated by one of the non-executive directors seeking to establish his due diligence defence by reference to statements made at a directors meeting by the executive directors that the disclosures in the registration statement were accurate.<sup>66</sup> Judge McLean had little difficulty in concluding that the receipt of such general assurances would not form the basis of the defence. What is very clear when the facts of the *BarChris Case* are closely considered is how woefully inadequate the inquiries conducted by these non-executive directors were.<sup>67</sup> Again the *BarChris Case* is consistent with English and Commonwealth authorities such as *J P Coats v Crossland*, *Stevens v Hoare* and *Adams v Thrift* on this point. Indeed, Judge McLean relied on the authority of *Adams v Thrift*.<sup>68</sup>

While each non-executive director failed to establish the due diligence defence for the non-expertised portions of the prospectus, each was able to rely on the due diligence defence for the expertised portions of the prospectus. Each of the non-executive directors had no reason to suspect that the statements containing the expertised portions of the prospectus were incorrect. Judge McLean considered that in these circumstances it was sufficient that those directors were

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<sup>63</sup> The non-executive with engineering qualifications and the non-executive with a banking background.

<sup>64</sup> Judge McLean ruled the length of time the director had been on the issuer's board was an irrelevant consideration - "Section 11 imposes liability in the first instance upon a director, no matter how new he is" - *BarChris Case* at 688.

<sup>65</sup> The director had reviewed Dun & Bradstreet reports on the issuer, and made inquiry of the issuer's bankers and financial factors (*BarChris Case* at 687). The other director had approached the issuer's brokers and visited the issuer's offices (*BarChris Case* at 689). The underwriter/director also sought to rely on such general non-specific inquiries as the basis of his due diligence defence - *BarChris Case* at 693.

<sup>66</sup> *BarChris Case* at 689. On the other hand the other director did not even do this although he was present at the board meeting when these inquiries were made (*BarChris Case* at 688).

<sup>67</sup> It is relevant to note that both directors had sufficient time to make inquiry if they had chosen to do so and while non-executive directors, had sufficient leverage to ensure any concerns they may have had were resolved - see *Folk 1 (1969)* at 30.

<sup>68</sup> *BarChris Case* at 688.

familiar with the reputation of the auditor<sup>69</sup> and had confidence in the skills and expertise of that auditor. Therefore for the non-executive directors a very low threshold of inquiry was imposed to establish the due diligence defence for the expertised portions of the prospectus.<sup>70</sup>

The *BarChris Case* was closely followed in 1971 by the Eastern District New York decision in *Feit v Leasco Data Processing Equipment Corporation*. The *Feit Case* is a strong affirmation of the analysis in the *BarChris Case*.<sup>71</sup> Judge Weinstein found that the disclosure document contained a material omission in that it failed to disclose the offeror's estimates of surplus insurance funds that could be used by the offeror for investment purposes.<sup>72</sup>

The issuer and other defendants raised the defence that they were unable to calculate with any precision the amount of surplus without the assistance of the target. The takeover was initially hostile, although by the end of the offer period the target was co-operating with the issuer. Judge Weinstein found that the issuer did in fact have estimates available to it,<sup>73</sup> and the fact that the amount was difficult to calculate should not have prevented appropriate disclosures of the estimates. The case therefore reflects the imposition of liability for an omission involving soft information. The analysis in Section 6.3 therefore becomes relevant.

None of the three director defendants was able to establish the due diligence defence. Two of the directors were executives while the other director was a partner in the offeror's law firm who had acted for the issuer for many years.

Judge Weinstein had little difficulty in finding that each of the director defendants had actual knowledge of the matters omitted. Their defence was that they each considered that the estimates available were unreliable and that more accurate estimates could not be obtained. Judge Weinstein found that no attempt had been made to determine if more reliable estimates were available and there was no reasonable basis for the directors to believe that an omission of the

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<sup>69</sup> Peat Marwick.

<sup>70</sup> See *Folk 1 (1969)* at 27.

<sup>71</sup> The facts of the *Feit Case* related to a scrip takeover offer for an insurance company. The offer of securities contained in the scrip takeover offer constituted an offering for the purposes of the United States securities laws, attracting the operation of section 11.

<sup>72</sup> These surplus funds were known as "surplus surplus" in insurance company jargon - see description in *Feit Case* at 550-1. Neither was it disclosed that the availability of this "surplus surplus" was the principal attraction for the offeror in undertaking the takeover offer.

<sup>73</sup> A government report was available to the offeror estimating the target's surplus surplus (*Feit Case* at 551). That report formed the basis of the offeror's initial interest in the target. In addition an internal report prepared by an officer of the offeror analysing the proposed transaction estimated the amount of surplus surplus.

estimates that were available was not materially misleading.<sup>74</sup> The judge's comments in this regard are of interest when compared to the reliability issue for disclosure of soft information as discussed in the *GIO* case in Section 6.3 above. Clearly, the *Feit Case* is an illustration as to how far the United States cases had moved from the historical treatment of soft information as immaterial for purposes of the securities laws.

In assessing the position of directors the analysis of the *BarChris Case* was endorsed. The position for conduct of due diligence by directors generally was summarised as follows by Judge Weinstein:

“What constitutes “reasonable investigation” and a “reasonable ground to believe” will vary with the degree of the involvement of the individual, his expertise, and his access to the pertinent information and data. What is reasonable for one director may not be reasonable for another by virtue of their differing positions ... Inside directors with intimate knowledge of corporate affairs and of the particular transactions will be expected to make a more complete investigation have more extensive knowledge of facts supporting or contradicting inclusions in the registration statements than outside directors. ...

*BarChris* imposes such stringent requirements of knowledge of corporate affairs on inside directors that one is led to the conclusion that liability will lie in practically all cases in misrepresentation. Their liability approaches that of the issuer as guarantor of the accuracy of the prospectus.”<sup>75</sup>

The reference to executive directors being “guarantors” of accuracy is of obvious significance. However it must be appreciated that the *Feit Case* is a clear example of a situation where the omitted matter was in fact the *raison d'être* for the transaction in question.

A particularly hard line was also taken in relation to the position of the lawyer/director. Judge Weinstein referred to the *BarChris Case* analysis of such a director as having “outside director” status but held the director to a very high standard of independent investigation because of his peculiar expertise. The judge stated that a director performing a legal role in some cases will be so intimately involved in the affairs of the issuer that insider status should attach to his position.<sup>76</sup> In the *Feit Case* the lawyer/director was therefore treated by Judge Weinstein as being essentially in the same position as the executive directors because of the period he had been a director (three

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<sup>74</sup> *Feit Case* at 578-9. It should be noted that 3 months after the preparation of the disclosure document a registration statement for a capital raising by the offeror was registered that disclosed an estimate of the target's surplus surplus. *Feit Case* at 560 (described by Judge Weinstein as “highly significant”).

<sup>75</sup> *Feit Case* at 577-8.

<sup>76</sup> *Feit Case* at 575-6 referring to *Folk I (1969)* at 39.

years), his involvement in all aspects of the proposed takeover and his involvement in the preparation of the disclosure document.<sup>77</sup>

The approach of the courts in the *BarChris Case* and the *Feit Case* have been endorsed in a number of subsequent United States decisions.<sup>78</sup>

### 7.3 ASSESSMENT OF THE POSITION OF DIRECTORS

Clearly the case law outlined above provides useful guidance as to the likely issues that will need to be considered by contemporary courts when the prospectus provisions become the subject of detailed consideration.

Those key issues are first the standard of conduct expected of a director, second the nature of enquiry required of a director and third the ability to delegate the director's responsibilities to others.

Each of these issues will be considered in turn.

#### General Standard of Conduct

The traditional director defence that mandates reasonable inquiries by the director in the making of prospectus disclosures bears a close analogy to the formulation of the directors general duty of care, skill and diligence both at general law and under the current section 180 of the *Corporations Act*.

That there is a close analogy between a reasonable inquiry requirement in the prospectus context and the common law duty of care, skill and diligence can be illustrated by the approach of the courts in cases such as *Adams v Thrift* and the requirement that the director satisfy a requirement of appropriate inquiry based on the standard of a reasonable man. That is a formulation relatively consistent with the director duty of care, skill and diligence as it was expressed by the courts in the early years of this century. This proposition is demonstrated in the 1990 New Zealand

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<sup>77</sup> *Feit Case* at 576.

<sup>78</sup> See by way of illustration of express endorsement *Competitive Associates, Inc v International Health Sciences, Inc* [1975 Transfer Binder] Fed Sec L Rep (CCH) 97,321 (SDNY); *Goldstein v Alodex Corp* 409 F Supp 1201 (ED Pa 1976); *Ahearn et al v Gaussoin et al* [1985 Transfer Binder] Fed Sec L Rep (CCH) 92,332 (D Or); *Laven et al v Flanagan et al* 695 F Supp 800 (DNJ 1988); *In re Software Toolworks, Inc Securities Regulation* 789 F Supp 1489 (ND Cal 1992).

It can be argued that many of these later cases illustrate a more lenient approach than reflected in the *BarChris Case*, at least in the results of the cases.

criminal prospectus misstatement case of *R v Rada Corporation Limited*.<sup>79</sup> The due diligence defence was briefly discussed. The judge indicated that, in determining the due diligence inquiry obligation which would apply to each director, he would apply the tests of duty of care, skill and diligence contained in the seminal directors' duty case of *In Re City Equitable Fire Insurance Company*. On this basis the judge said that the non-executive directors would likely be able to establish the due diligence defence, although the position was said to be less clear for executive directors.<sup>80</sup>

The analogy also applies in the United States between the due diligence defence of section 11 of the *Securities Act* and the general duty of care under United States law.<sup>81</sup>

There have been significant recent developments in the law relating to the director duty of care, skill and diligence.<sup>82</sup> The development of the law was brought into sharp relief in Australia during the 1990s by the *AWA case*.<sup>83</sup> A strengthening of the obligations imposed on a director in meeting the duty of care, skill and diligence were endorsed by a number of reviews, particularly following the 1987 stock market collapse.<sup>84</sup> Perversely, the law was not strengthened but

<sup>79</sup> *R v Rada Corporation Ltd & Ors* (1990) 5 NZCLC 96,413. The facts of this case are set out at footnote 138 of Chapter 2.

<sup>80</sup> *Id* at 66,647-8. The position would clearly have been much more difficult for the executive directors as they were responsible for arranging the parent company funding in question.

<sup>81</sup> See the analysis in *Folk I* (1969) at 42-5. While the section 11(c) definition of reasonableness is a statutory pointer to the analogy of the duty of care (being changed from an original trustee standard adopted in 1933 to the current standard in 1934), the common genesis of the United States legislation from England makes the comparison valid.

It has been suggested that a similar provision to section 11(c) in the Pennsylvania Business Corporation imposes a stricter standard than the general director duty standard of diligence - see *Selheimer v Manganese Corporation* 224 A 2d 634 (1966) (discussed in *Sievers* *infra* at 121). On this analysis the prudent man test of section 11(c) is a higher standard because it requires the directors to ask what they would do with their own money, not other people's money.

<sup>82</sup> See Trebilcock "The Liability of Company Directors for Negligence" (1969) MLR 477; Mackenzie "A Company Directors Obligations of Care and Skill" [1982] JBL 460; J.D. Cox "Changing Perceptions Into Reality: Fiduciary Standards to Match the American Directors Monitoring Function" (1989) 1 Bond LR 218; A. Black "Recent Developments in Directors Duties" (1990) 7 Aust Bar Rev 121; V. Finch "Company Directors: Who Cares About Skill and Care?" (1992) 55 MLR 179; A.S. Sievers "Farewell to the Sleeping Director - The Modern Judicial and Legislative Approach to Directors' Duties of Care, Skill & Diligence" (1993) 21 ABLR 111; Note (J. Hill) "The Liability of Passive Directors: *Morley v Statewide Tobacco Services Ltd*" (1992) 14 Syd L Rev 504; J. Cassidy "An Evaluation of Section 232(4) of the Corporations Law and the Directors Duty of Care, Skill and Diligence" (1995) 23 ABLR 184; M. Whincop "A Theoretical and Policy Critique of the Modern Reformulation of Directors Duties of Care" (1996) 6 AJCL 72; G. Stapleton "The CLERP Proposal in Relation to Section 232(4): The Duty of Care and Diligence" (1998) 16 C&SLJ 144; J. Bird "The Duty of Care and the CLERP Reforms" (1999) 17 C&SLJ 141.

<sup>83</sup> *Daniels & Ors (formerly practising as Deloitte Haskins & Sells) v Andersen & Ors* (1992) 7 ACSR 759 and 9 ACSR 383 (SC NSW, Rogers J) and (1995) 16 ACSR 607 (SC NSW, Court of Appeal) (referred to in this chapter as the *AWA case*). For an overview see R Baxt "One AWA Case is not Enough: The Turning of the Screws for Directors" (1995) 13 C&SLJ 414; A. Comerford & L. Law "Directors' Duty of Care and the Extent of "Reasonable" Reliance and Delegation" (1998) 16 C&SLJ 103.

<sup>84</sup> Both the *National Companies Bill 1976* of the then Labour Government and the first draft of the *Companies Bill 1980* contemplated a more objective standard of conduct in relation to the duty of care, skill and diligence. A more objective standard was endorsed in the early 1990s by the Cooney Report - Senate Standing Committee on Legal and Constitutional Affairs "Report on the Social and Fiduciary Duties and Obligations of Company Directors" (1989, AGPS) at Chapter 3 - and the Lavarch Report - House of Representatives Standing Committee on Legal and Constitutional Affairs "Corporate Practices and the Rights of Shareholders" (1991, AGPS).

potentially weakened at the end of the 1990s by the enactment of the *CLERP Act* and its introduction of a safe harbour in the “business judgment” rule.<sup>85</sup>

The starting point of analysis is the statements of general principle most authoritatively laid out by Romer J in *In Re City Equitable Fire Insurance Company*.<sup>86</sup> Romer J imposed a reasonable care requirement on a director in establishing the duty of care, skill and diligence:

“the care that he is bound to take has been described ... as “reasonable care” to be measured by the care an ordinary man might be expected to take in the circumstances on his own behalf.”<sup>87</sup>

That proposition is philosophically consistent with the approach of the earlier case *Stevens v Hoare* extracted above. The seemingly objective nature of the reasonable care/ordinary man test imposed by the standard was said by Romer J to be tempered by a number of subjective elements. First Romer J said that regard must be had to the actual skills and position of the director in question:

“A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. A director of a life insurance company, for instance, does not guarantee that he has the skill of an actuary or physician.”<sup>88</sup>

Second, Romer J stressed the intermittent nature of the exercise by the director of his powers:

“A director is not bound to give continuous attention to the affairs of his company, His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so.”<sup>89</sup>

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<sup>85</sup> Section 180 of the *Corporations Act*.

Despite the analogy drawn to the common law duty of care, skill and diligence here the business judgment rule is not relevant to the analysis of the director defence because the business judgment rule is only expressed to be applicable to the statutory duty of care and their equivalent duties at common law and in equity (see section 180(2)).

Further the statutory duty of care may differ in some respects from the common law analysis - see for example *Byrne v Baker* [1964] VR 443 and the comment that the removal of the word “skill” from the statutory formulation was a significant omission (at 450).

<sup>86</sup> *In Re City Equitable Fire Insurance Co Ltd* [1925] 1 Ch 407.

<sup>87</sup> *Id* at 428.

<sup>88</sup> *Id* at 428. More recent Australian case law suggests that personal deficiencies need not be taken into account when applying this standard - see *Gamble & Anor v Hoffman & Anor* (1997) 24 ACSR 369 (FCA, Carr J) (need not take in to account that director left school at 14 and has spent his life as a market gardener - at 373); *AWA Case* at 16 ACSR 665.

<sup>89</sup> *Id* at 429.

In the *AWA case* it was observed that the law concerning the duty of directors has not stood still in the 70 years since *In Re City Equitable Fire Insurance Company* was handed down. The *AWA case* involved foreign exchange losses incurred in circumstances where management and control systems that might have exposed those losses did not exist. The auditor was aware of the defects and was sued by the company for the recovery of the losses. The auditor counterclaimed that the board was negligent in not having in place the appropriate control systems.

The *AWA case* demonstrates that directors are now clearly under a duty to take steps to become familiar with the company's affairs:

“We are of opinion that a director owes to the Company a duty to take reasonable care in the performance of the office. ... That duty will vary according to the size and business of the particular company and the experience and skills that the director held himself or herself out to have in support of appointment to the office. None of this is novel. It turns upon the natural expectations and reliance placed by shareholders on the experience and skill of a particular director. ... The duty includes that of acting collectively to manage the company.”<sup>90</sup>

As such, the court in the *AWA case* required that the directors as a group ensure that they were in a position to properly monitor the performance of the company:

“In our opinion the responsibilities of directors require that they take reasonable steps to place themselves in a position to guide and monitor the management of the company. The board of *AWA* met only once a month for half a day. But to our mind the board should meet as often as it deems necessary to carry out its functions properly. The question is what in the particular case are the duties and responsibilities of the directors and then what time is required of them as a board to carry out these duties and responsibilities. It is not a matter of tailoring the extent of the duty or function to prefixed intervals between board meetings.”<sup>91</sup>

The approach of the *AWA case* therefore supersedes the second proposition of Romer J outlined above. Clearly that result is appropriate from the policy perspective having regard to contemporary expectations of the work of directors<sup>92</sup> and is consistent with the approach of Australian courts in analogous situations, particularly under the insolvent trading legislation.<sup>93</sup>

As such:

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<sup>90</sup> *AWA case* at 668.

<sup>91</sup> *AWA case* at 664.

<sup>92</sup> See *Finch* supra at 201-3; *Hill* supra at 509.

<sup>93</sup> The leading cases in these developments are *Morley v Statewide Tobacco Services Ltd* (1992) 8 ACSR 305 (SC Vic (Full Court), Crockett, Southwell & Hedigan JJ); *Group Four Industries Pty Ltd v Brosnan & Anor* (1992) 8 ACSR 463 (SC SA (Full Court), Matheson, Olsson & Debelle JJ); *Commonwealth Bank v Friedrich & Ors* (1991) 5 ACSR 115; *Rema Industries and Services Pty Ltd v Coad & Ors*; *Re Taspac Thermoforming Pty Ltd* (1992) 7 ACSR 251 (FCA, Lockhart J). In the director duty context see also *Australian Securities Commission v Gallagher* (1992) 10 ACSR 43 at 53 and *Permanent Building Society (in liq) v Wheeler & Ors* (1994) 14 ACSR 109 at 159.

“The days of the sleeping, or passive, director are well and truly over.”<sup>94</sup>

To satisfy the duty of care, skill and diligence inquiry is therefore required. The question arises as to how the inquiry obligations differ between the duty already imposed on the director and under CA section 731.

It would seem that there is very little distinction from the perspective of specifying the legal test. The fundamental distinction would seem to be a practical one. The preparation of a prospectus requires formal disclosures to be made concerning the issuer. As such, those disclosures become the focus of director attention with the duty of inquiry attaching to that activity. The legal definition of the content of the obligation is essentially identical to the director’s general duty to the company.<sup>95</sup>

### **The Duty as applied to Individual Directors**

As noted above, the first proposition established by Romer J was that regard must be had to the actual skills and position of the director in question. That general proposition is long established as a matter of English and Australian law and is endorsed by the *AWA case* in its reference to the duty varying according to the size of the business of the particular company and the experience and skills the particular director holds herself out as having. To date, calls for a more objective standard that requires minimum skills for an individual director have been rejected.<sup>96</sup>

The United States material on the prospectus due diligence defence suggests the content of the duty is strongly influenced by the actual skills possessed by the director and the executive/non-executive distinction. This had led to the proposition in the *BarChris Case* and the *Feit Case* that executive director functions are such that they assume “guarantor” status for the disclosures in the prospectus and that a director with skills such as a lawyer will be held to a standard approaching insider or executive status.

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<sup>94</sup> *AWA case* at 663 citing *Statewide Tobacco Services Ltd v Morley* [1993] 1 VLR 423.

<sup>95</sup> A contrary statutory proposition could conceivably be mounted by the use of the antiquated words “if any” in the relevant provisions of CL section 731. It has been suggested that those words in fact impose a reduced duty in the prospectus context to the general context of the director duties of care, skill and diligence (see *Turner (1989)* at 109 and *Feit Case* at 31). Clearly that argument is unlikely to find favour before modern Australian courts because of the importance of care in the capital raising process.

<sup>96</sup> For criticism see *Report on the Social and Fiduciary Duties and Obligations of Company Directors* (“Cooney Report”) (1989, AGPS) and *Corporate Practices and the Rights of Shareholders* (“Lavarch Report”) (1991, AGPS).

It has been argued that the effect of the *Cooney Report* and the amendments made to the statutory formulation of the general duty of care, skill and diligence by the amendments to section 232(4) of the *Corporations Law* in 1992 have expressly imposed an objective duty of care on directors - see *Comerford & Law supra* at 106-8 but for a contrary view see *Cassidy supra* at 115. See also *Bird supra* at 142-144.

By way of contrast, in Commonwealth cases such as the New Zealand decision of *Deloitte Haskins & Sells v National Mutual Life Nominees*<sup>97</sup> arguments that a non-executive director should be subject to a lower standard of care than executive directors have been rejected.<sup>98</sup>

A subtle distinction therefore arises in the way the applicable duty of care is applied to different individuals. As has been noted by Professor Folk in the United States there are basically two policy choices available in addressing the nature of the standard of care and diligence as it is applied to different individuals.<sup>99</sup> The first approach can be described as a “fixed standard” where the legal content of the standard is fixed but that standard will produce different requirements of care and diligence when applied to different people and different fact situations. The fixed approach would provide that the standard of care imposed on the executive and non-executive is the same but in establishing whether the standard is satisfied the individual directors role and skills are relevant considerations. The second approach can be described as a “variable standard” where the legal content of the duty possesses a different content as applied to various persons and fact situations. The variable approach would, for example, provide that the standard required of an executive would differ from that of a non-executive as would the standard required of a director with special skills.

United States cases such as the *BarChris Case* and the *Feit Case* are a clear endorsement of the second approach.<sup>100</sup> In the *AWA case* it would seem that the decision of Rogers J was supportive of the variable standard approach, at least so far as the executive/non-executive distinction is concerned, while the Court of Appeal decision suggests support for the fixed standard approach.

Rogers J had said that a chief executive officer must exercise the skill required of a person in that position but, for the non-executive, the diversity of companies has the result that there is no applicable objective standard.<sup>101</sup>

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<sup>97</sup> *Deloitte Haskins & Sells v National Mutual Life Nominees* (1991) 5 NZCLC 67,418.

<sup>98</sup> *Ibid* at 67,442-3.

<sup>99</sup> *Folk I* (1969) at 42. For other attempts to formulate the test having regard to differing skills and expertise see *Finch* supra note 159 at 203; *Trebilcock* supra at 511; *Mackenzie* supra at 475.

<sup>100</sup> For illustrations in the prospectus context see *Laven v Flanagan et al* 695 F Supp 800 (DNJ 1988) at 812. See also the discussion in *White* (1993) at 313-5.

<sup>101</sup> *AWA case* at 807.

“Generally a chief executive is a director to whom the board of directors has delegated its powers of management of the corporations business..... the chief executive will exercise the care and skill to be expected of a person in that position. The degree of skill required of an executive director is to be measured objectively. In contrast to the managing director, non executive directors are not bound to give continuous attention to the affairs of the corporation. Their duties are of an intermittent nature to be performed at periodic board

On the other hand, the Court of Appeal did not distinguish between executive and non-executive directors in imposing the duty of care. Instead the focus of analysis was on the need to undertake all necessary steps to guide and monitor the company as assessed by reference to the actual knowledge and skills of the particular director. The court suggested that the diversity and complexity of modern companies had the result that it would be unreasonable to impose an objective standard of care.<sup>102</sup>

Neither decision definitively expressed a view on whether the standard of care is fixed or variable. As such, the position remains unclear.<sup>103</sup>

The distinction between a fixed standard and a variable standard of care has important practical and policy consequences:

“The first approach avoids the difficult task of formulating various sub-standards within the coverage of one general standard. Although it has the advantage of permitting the court to manipulate application of the standard to the facts, this flexibility tends to make decisions ad hoc and prediction difficult. In the second approach, conceding the difficulty of formulating workable legal rules, exposes the issue clearly. Furthermore, it is more consonant with policy orientated analysis which recognises the role of legislative history, statutory purpose, results in a given case and impact for the future.”<sup>104</sup>

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meetings, and at meetings of any committee of the board upon which the director happens to be placed. Notwithstanding a small number of professional company directors there is no objective standard of the reasonably competent company director to which they may aspire. The very diversity of companies and the variety of business endeavours do not allow of a uniform standard”.

<sup>102</sup> *AWA case* at 867.

“to our mind the board should meet as often as it deems necessary to carry out its functions properly. The question is what in the particular case are the duties and responsibilities of the directors and then what time is required of them as a board to carry out these duties and responsibilities. It not a matter of tailoring the extent of the duty or functions to pre-fixed intervals between board meetings.

To be balanced against calls that the modern public company director has acquired and now asserts professional status together with the professional skills (which should carry a requirement the director conform to professional standards and the imposition of an objective standard of care which would not yield to considerations such as lack of knowledge or lack of experience) are the difficulties deriving from the variety of businesses with which companies may be concerned and from the highly diversified activities of a large and complex company. In such circumstances it would be unreasonable to expect every director to have equal knowledge and experience of every aspect of the company’s activities.”

<sup>103</sup> See the debate noted at footnote 99. In *Baxt* supra at 421 criticism is made of the failure to maintain the executive/non-executive distinction in the *AWA Case*.

Section 180(1) of the *CLERP Act* introduced a new statutory formulation of the duty of care, skill and diligence. Under section 180(1) a director must discharge their duties with the degree of care and diligence that “a reasonable person would exercise” if they were a director in the company’s “circumstances” and “occupied the office held by, and had the same responsibilities” within the company as the director. This formulation would seem to direct the imposition of a variable standard, which is also suggested by the supporting material - see paragraph 6.2 of *CLERP Proposals for Reform: Paper No. 3 “Directors Duties and Corporate Governance”* and paragraphs 6.73 - 6.75 of the *CLERP Bill*.

This material is not directly relevant to an assessment of the operation of Chapter 6D because of the lack of similar language in section 731 to refine the standard of care expected of the director.

<sup>104</sup> *Folk I (1969)* at 42.

Similarly Hill has commented:

“Differentiation between directors and management on the basis of the former’s monitoring role opens the way to a more finely tuned approach to the question of what a director “ought to know” to properly discharge the duties of office.”<sup>105</sup>

The conclusion of the above analysis is that the variable standard analysis of the United States material on prospectus due diligence should be treated with some caution in light of the approach of the Court of Appeal in the *AWA case*. However, the difference in the emphasis of legal analysis of the standard does not alter the likely outcome of a particular case and therefore the relevance of the United States case law to the Australian context.

In assessing the Australian due diligence structure described in Section 4.4 against this legal analysis it is clear that the director:

- must be actively involved in the review of the disclosures contained in the prospectus and must appreciate and monitor the work conducted by the due diligence committee. The due diligence committee structure cannot be treated as a rubber stamp. However the case law supports an approach of group inquiry as is reflected by the committee structure;
- must believe in the accuracy and completeness of the disclosures in the prospectus;
- must bring to bear the skills and knowledge that the particular individual has;
- if an executive, will be held to a high standard of responsibility for bringing forward to the due diligence committee relevant information known within the organisation.

The prospectus cases demonstrate that the period of time the director has been in office is not relevant to these considerations and that general inquiries in relation to the issuer, such as inquiries undertaken in deciding whether to join the board, are not sufficient.

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<sup>105</sup> *Hill supra* at 509. See also *Finch supra* at 202-3.

For recent Australian support for a variable standard in the analogous situation of the duty of a trustee see *Australian Securities Commission v AS Nominees and Ors* (1995) 18 ACSR 459 at 470-1 (addressing the issue of whether a professional trustee company professing to have special skills has a higher duty of care).

For advocacy of a variable standard of care in the Canadian context see *Simmonds (1979)* at 640-645.

## Delegation of Inquiries

The case law has consistently recognised the practical reality that a director must delegate enquiry functions as part of the prospectus preparation process. The due diligence structure described in Section 4.4 is predicated on a structure of director delegation and reliance.<sup>106</sup> As such it is critical to appreciate the boundaries of this aspect of the due diligence defence.

The *Stevens v Hoare* case is clear authority for the proposition that it is permissible for a director to delegate enquiries in order to satisfy the due diligence requirement of CA section 731.<sup>107</sup> In addition CL section 733 now specifically mandates “reasonable reliance” as a separate defence.

An immediate qualification to reliance is suggested by the early cases where a self-interested party is involved, such as in the *J P Coats v Crossland* case and in *Adams v Thrift*. However, the case law suggests that issue does not generally arise for the director where the delegation and reliance involves officers of the company or advisers retained by the company. The early prospectus cases concerning director reliance on officers and advisers is consistent with case law involving director duties generally. For example it was stated by the House of Lords in the 1901 decision of *Dovey v Cory*<sup>108</sup> that:

“the argument raises a serious question as to the responsibility of all persons holding positions like that of directors, how far they are called upon to distrust and be on their guard against the possibility of fraud being committed by their subordinates... I cannot think that it can be expected of a director that he should be watching either the inferior officers of the bank or verifying the calculations of the auditors himself. The business of life could not go on if people could not trust those who are put into a position of trust for the express purpose of attending to details of management.”<sup>109</sup>

In each of these cases it is important to appreciate that the director in question has no reason to doubt:

- the appropriateness of the person delegated the enquiry function for the task in question;

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<sup>106</sup> Delegation and reliance is now expressly acknowledged in the *Corporations Act* in connection with a formal delegation of board powers - section 190(2). Critically, the director must believe “after making proper inquiry if the circumstances indicate the need for inquiry” that the delegate was reliable and competent.

<sup>107</sup> For a further case in the prospectus context see *In re Brazilian Rubber Plantations and Estates, Limited* [1911] 1 Ch 425 (advisors commissioned by English directors to inspect rubber plantations in a remote part of Brazil to be owned and operated by the issuer).

<sup>108</sup> *Dovey & The Metropolitan Bank (of England & Wales), Limited v Cory* [1901] AC 477 a case involving allegations that dividends were paid by directors out of capital. The director had authorised the dividend payment on the basis of balance sheets which had fraudulently been prepared by management. The director had no knowledge of the fraud.

<sup>109</sup> *Ibid* at 485-486 (Earl of Halsbury LC).

- the probity of that person (the promoter cases being explained on this basis); and
- that there were no follow up issues that required attention.

The early case law on delegation and reliance in relation to directors duties was summarised by Romer J in *In Re City Equitable Fire Insurance Company* as follows:

“In respect of all duties that having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.”<sup>110</sup>

As such, the prospectus law relating to delegation and reliance adopted the same principles as the law relating to director duties generally.

There has been a large body of case law in many jurisdictions which supports the general propositions on delegation and reliance outlined above.<sup>111</sup>

The key issue in contemporary society is to what extent the director needs to second guess the work of management or others before the director is entitled to rely on that work. This is the key issue of contention that comes out of the *AWA case*.

At first instance in the *AWA case*, Rogers J had said the threshold of inquiry to justify reliance was very low. The case law noted above was referred to as a basis for the right of a director to delegate and rely on that delegation. Rogers J then went on to say the following:

“The business of a corporation could not go on if directors could not trust those who are put into a position of trust for the express purpose of attending to details of

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<sup>110</sup> Supra at 429. Romer J supported this conclusion by citing the Court of Appeal and House of Lords in *Dovey v Cory*. Romer J also said in this context that directors are not bound to examine entries in the company's books (at 430) citing *Hallmarks Case* (1878) 9 Ch D 329 and *In Re Denham & Co* (1883) 25 Ch D 752.

<sup>111</sup> Notable cases include *In re Denham & Co* (1883) 25 Ch D 752 at 766 (director may rely on auditor); *Prefontaine v Greiner* [1907] AC 101 (director may rely on officer who had permitted irregular loans leading to collapse of company); *Ammonia Soda Co v Chamberlain* [1918] 1 Ch 266 (director not guilty of negligence if rely on officers they are entitled to trust); *Huckerby v Elliott* [1970] All ER 189 (director entitled to rely on fellow director and secretary); *Dorchester Finance Company Limited & Anor v Stebbing & Ors* [1989] BCLC 498 (reliance by non executive director on auditors not responsible when signing blank cheques); *Norman & Anor v Theodore Goddard & Anor v Theodore Goddard & Ors (Quirk, Third Party)* [1992] BCC 14; (1992) 10 ACLC 3016 (reliance by non-executive director on fraudulent lawyer reasonable in relation to investment of funds involving international tax law and offshore finance considerations); *Australian Securities Commission v Gallagher* (1993) 10 ACSR 43 ((SC) WA, Franklyn J, Walsh J, Pidgeon J) (non-executive reliance permitted); *Biala Pty Ltd & Anor v Mallina Holdings Ltd & Ors* (1993) 11 ACSR 785 (non-executive director reliance on CEO permitted in circumstances and CEO reliance on shareholder permitted); *Vrisakis v Australian Securities Commission* (1993) 11 ACSR 162 (adopts statements of Rogers J in *AWA Case*); *Permanent Building Society (in liq) v Wheeler & Ors* (1944) 14 ACSR 109 (reliance by managing director on others not permissible in circumstances); *Dairy Containers v NZI Bank Ltd* [1995] 2 NZLR 30 (inadequate supervision).

It is also worth noting that the background materials to the amendments to section 11 of the *Securities Act* 1933 in 1934 specifically acknowledged the need for delegation so far as directors are concerned. This was a contentious issue with the original 1933 legislation. See *Landis* (1959) at 47-8.

management: American Law Institute “Principles of Corporate Governance, Analysis and Recommendations” pp 75, 176. Reliance would only be unreasonable where the director was aware of circumstances of such a character, so plain, so manifest and so simple of appreciation that no person, with any degree of prudence, acting on his behalf, would have relied on the particular judgment information and advice of the officers: *Re City Equitable Fire Insurance Co*, supra, 428. A non-executive director does not have to turn him or herself into an auditor, managing director, chairman or other officer to find out whether management are deceiving him or her: *Graham v Allis-Chalmers Manufacturing Co* 188 A 2nd 125 at 130.”<sup>112</sup>

Most of the statements made by Rogers J are unexceptional and consistent with the early case law described above except for the fairly extreme statement that the reliance would only be unreasonable where no person with any degree of prudence would rely on the officer.<sup>113</sup> Rogers J referred to page 428 of Romer J’s judgment in *Re City Equitable* to support this view but, with respect, there is little in that citation to support the proposition.<sup>114</sup> The Court of Appeal in the *AWA case* specifically overruled Rogers J on the issue of the threshold of inquiry required to justify reliance:

“In our respectful opinion it does not accurately state the extent of the duty of directors, whether non-executive or not, in modern company law.”<sup>115</sup>

The court referred to a number of United States decisions to develop the following general propositions:<sup>116</sup>

- the director must have an understanding of the business of the company;

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<sup>112</sup> *AWA case* at 868. Further, Rogers J considered that directors are entitled to rely on auditors without themselves reviewing the accounting records:

“In relation to auditors, if directors appoint a person of good repute and competence to audit the accounts, absent real grounds for suspecting that the auditor is wrong, the directors will have discharged their duty to the corporation. The directors are not required to look at the entries in any of the corporation’s books of record, or verify the calculations of the corporation’s accountants in preparing the financial statements or of the auditor himself. Directors are entitled to rely on the judgment, information and advice of the auditor: cf *Re Denham & Co* [1883] 25 Ch D 752 at 766; *Dovey v Cory*, supra, at 486, 492). Reliance may properly be more complete where the auditor is acknowledged as being more knowledgeable, skilled and experienced in the particular matter in question than the directors or other auditors.”

<sup>113</sup> It has therefore been argued on this basis that where a matter is of great importance then it will remain the director’s responsibility and that while the director may delegate such a responsibility they may only rely on the results of delegation and not the mere fact of delegation - see *Comerford & Law* supra at 111. This assessment gives rise to concerns of indeterminacy when applied to particular factual circumstances.

<sup>114</sup> Romer J at that reference had cited the decision of *Overend & Gurney Co v Gibb* (1872) LR 5 HL 480 concerning the distinction between liability in negligence and gross negligence. The closest statement in a prior case supporting the Rogers view was *Huckerby v Elliott* supra at 194 (Lord Parker CJ of the English Court of Appeal).

<sup>115</sup> *AWA case* at 665. Clarke & Sheller JJA similarly note the source of Roger J’s statement concerning reliance from *Overend & Gurney v Gibb* “in describing crassa negligentia”.

<sup>116</sup> Citing principally *Federal Deposit Insurance Corporation v Bierman* 2 F 3d 1424 (1993); *Rankin v Cooper* 149 F 1010 (1907); *Francis v United Jersey Bank* 432 A 2d 814 (1981).

- the director is under a continuing obligation to be kept informed of the activities of the company;
- the directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct they did not have a duty to look;
- in monitoring the activities of the company directors may be under a duty to enquire further into matters where suspicions are raised or where a prudent person would be concerned.

Only if the above requirements are complied with by the director will they be entitled to rely on enquiries conducted on their behalf.

The view of the Court of Appeal as to what was required to properly rely on others was summarised by the following quote from *Federal Deposit Insurance Corporation v Stanley*:<sup>117</sup>

“All of the directors of a bank have a duty to be generally familiar with the business and financial conditions of the bank, and to devote a sufficient amount of time and energy to overseeing the affairs of the bank... a director’s duty to exercise due care, skill and diligence in overseeing the affairs of the bank cannot be met solely by relying on other persons.”

When the statements of Rogers J and the Court of Appeal in the *AWA case* are considered, it can be argued that the distinction is more one of emphasis on the role of monitoring rather than a fundamental rejection by the Court of Appeal of the basic concepts of delegation and reliance as has been developed above.<sup>118</sup>

The suggestion that a director has a positive obligation to establish control procedures and monitor management is unobjectionable as a matter of policy analysis.<sup>119</sup> The Court of Appeal in the *AWA case* explicitly imposed such a requirement before it considered that reliance on

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<sup>117</sup> *Federal Deposit Insurance Corporation v Stanley* 770 F Supp 1281 (ND Ind, 1991) at 1310

<sup>118</sup> This point can be established by reference to the 1899 Court of Appeal decision in *Dovey v Cory (In re National Bank of Wales, Limited [1899] 2 Ch 629)* where the Court of Appeal said (at 673) “Cases such as these are always cases of degree”. *Leeds Estate, Building and Investment Co v Shepherd* (1887) 36 Ch D 787 was referred to as a situation where reliance was not permitted because no supervision of a manager was undertaken by the directors of a manager who had delegated their functions to him. On the other hand *In re Denham & Co* was referred to as a case more like the facts then before the court.

For similar analysis see *Comerford & Law* supra at 112 and 118-119.

<sup>119</sup> For further analysis by reference to the United States case law see J.G. Hill “*Deconstructing Sunbeam-Contemporary Issues in Corporate Governance*” (1999) 67 *Uni of Cincinnati L Rev* 1099 at 1114-1120. Reference is made to more recent case law such as *In Re Caremark International, Inc Derivative Litigation* 698 A 2d 959 (Del Ch 1996) that suggests the approach reflected by earlier cases such as *Graham v Allis - Chalmers Manufacturing Co* (cited by Rogers J with approval in the above quote) have been superseded by an obligation of active monitoring before reliance is reasonable. For further discussion see H. Lowell Brown “*The Corporate Director’s Compliance Oversight Responsibility in the Post Caremark Era*” (2001) 26 *Del Jnl of Corp Law* 1.

delegated inquiries would be acceptable. It is useful in keeping the requirement in context to note that in the *AWA case*, the Court of Appeal ultimately upheld Roger J's finding on the facts that the non-executive directors were entitled to rely on the officers and auditors of AWA so as to establish that there had been no breach of their duties to AWA.<sup>120</sup>

The very fact specific nature of the position faced by the director is illustrated by reference to the 1990 New Zealand prospectus case of *R v Reid*.<sup>121</sup> In that case a director was discharged from a criminal trial by the judge on the basis that a reasonable jury could not bring in a guilty verdict against the director because the due diligence defence would be available to the director. The case involved an allegation of inflated profits in the audited accounts included in the prospectus. The judge would appear to have permitted a very high level of reliance on the part of the defendant non-executive directors in relation to the accounting records of the issuer, even though the evidence suggested little review of those accounting records by the directors.<sup>122</sup>

Clearly the approach of the *AWA case* would have required more of the directors in this situation, although ultimately, the same comment can be made as above that all these cases are cases of degree.<sup>123</sup>

Against the background of the preceding analysis it must be questioned if there is anything special about the due diligence defence that should modify the approach of the *AWA case* to

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<sup>120</sup> *AWA case* at 676. While the Court of Appeal was clearly troubled by the failure of the non-executive directors to become familiar with AWA's foreign exchange operations it would seem the negligent assurances received from both management and the auditor that everything was in order permitted the conclusion that Rogers J findings of fact not be overturned.

<sup>121</sup> *R v Reid & Anor* (1990) 5 NZCLC 96,393.

<sup>122</sup> *Ibid* at 66, 484 - 5.

"that the evidence ... establishes ... these two directors had reasonable grounds to believe that the accounts that had been prepared by the company, approved by the directors, approved by the auditor and adopted at the annual meeting, were correct. ... Mr Ivan Coffee [one of the accused] was not present at directors meetings between March and September [the relevant period in which the prospectus was distributed]. One might assume, although we do not know, that he probably had and read the minutes of directors meetings and other documents that were sent to directors. Mr Reid [the other director defendant] had been appointed a director of Kearns only a month or two before March 1988. He had before him the documents that had been presented and the minutes of the meetings of the directors. It is apparent that he expressed some enquiries and those persisted until he resigned in February of the following year. It is difficult to see what he, as a director, could reasonably have done in the period to have checked on the accuracy of what was presented before him, particularly in the light of this company where, from the evidence of Mr Blacklaws, the chief executive apparently was quite selective over what he informed his directors of and what he presented before them."

<sup>123</sup> One of the directors would appear to have been excused largely because of his failure to attend board meetings during the relevant period. The other director would appear to have been permitted to rely on assertions of self-interested management. While the misstatement would appear to have related solely to matters contained in audited accounts the decision makes no attempt to assess what inquiries the directors should have made of more independent parties such as auditors or what steps were taken by the directors to investigate the accounts in the period prior to signing the audited accounts.

It may be possible to rationalise the decision by emphasising the necessity for a court to assess the nature of the statement in question in determining what inquiries are reasonable and what steps could have been taken to verify the statements (as was noted in *Adams v Thrift*). In this case it may have been there was little a non-executive director could practically do to investigate the prospectus statement. On such a view the approach of the *AWA case* may not have lead to a greatly different result.

questions of delegation and reliance in the capital raising context. From the policy perspective it would seem that the Court of Appeal in the *AWA case* does strike a proper balance.

The above analysis of delegation and reliance has been very general in its terms. The question the director will wish to address is what those requirements mean in their particular case, after receiving the report of the due diligence committee and the lawyers and accountants. The case law demonstrates the fact specific nature of that question. Cases such as *Adams v Thrift* and the *BarChris Case* demonstrate a very poor standard of conduct on the part of the directors involved. No modern prospectus case illustrates a more finely balanced fact situation.

It has been suggested that in the United States the appropriate boundaries of delegation and reliance in the prospectus context should be as follows:

“the outside director in most cases should not have to undertake independent verification of facts from corporate books and documents. He should usually enjoy a “full discharge of his responsibilities” if he reads a registration statement with the care ordinarily evoked by warnings that he is liable for the contents of the document and if he then probes responsible personnel and their counsel on the detailed factual contents of the document. ... he should concentrate on sensitive areas such as the intended use of proceeds, the figures furnished by the company’s accounting department for the post-audit period, and the statements regarding the directors themselves (including their stock interests, loans and the like). These areas are well within his competence to investigate feasibly. ... An outside director - or, especially batteries of outsiders - bearing down heavily upon the insiders for several hours of insistent questioning and compelling them to prove their assertions, will best fulfill the role of directors.”<sup>124</sup>

These comments have much relevance to the Australian position. It should be that after:

- receiving the report of the due diligence committee and the lawyers and accountants;
- carefully reviewing the prospectus;
- requiring follow up reports in relation to any area of suspicion or concern,

the director should then be protected through the principles of delegation and reliance for any matter of which she was not aware as a result of undertaking that inquiry process. The cases particularly demonstrate a harsh treatment of persons who do not undertake tasks that could readily or easily have been done - that should be a particular matter of emphasis for the director.

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<sup>124</sup> *Folk I (1969)* at 70-1.

### A Particular Form of Delegation - Reliance on Legal Advice

So far the analysis of delegation and reliance has dealt with circumstances where general inquiry functions have been delegated and the director has no knowledge of a deficiency in the prospectus. A different issue of reliance arises where the director is aware of a matter and seeks a legal opinion as to whether the matter requires disclosure. What is the position of the director if advised that no disclosure is required, but a court later disagrees with the conclusion?

The House of Lords decision of *Shepherd v Broome* suggests that the receipt of such a legal advice will not constitute a reasonable grounds for belief for purposes of the due diligence defence because mistake of law is no defence. Other early case law would seem to support this proposition.<sup>125</sup>

It is a fundamental tenet of the common law that ignorance of the law is not an excuse to legal liability.<sup>126</sup> This issue generally arises in the context of the criminal law but is also relevant to statute law and the common law.<sup>127</sup> While ignorance of the law is not an excuse a mistake of fact may give rise to a valid defence - for example in the criminal law to negate mens rea or to establish the defence of honest and reasonable belief. Clearly these concepts are relevant to the CA section 731 defence regime because of the necessity that the directors believe that there is no misstatement.

The need to distinguish between questions of law and questions of fact is a notoriously difficult exercise:

“That it is not absolute is illustrated by the many cases said to turn on a mixed question of law and fact. Then there is the choice between two propositions - on the one hand that of Dixon J in this Court in *Thomas v The King* that “a mistake as to the existence of a compound event consisting of law and fact is in general one of fact and not a mistake of law” - on the other hand the rule that, when the facts are certain it is a

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<sup>125</sup> See *Tait v Macleay* [1904] 2 Ch 631 (reliance on assurance received from issuer's solicitor that all contracts required to be disclosed did not provide defence to the 1867 *Material Contracts Act*); *Watts v Bucknall* [1903] 1 Ch 766 (director cannot avoid liability under the 1867 *Material Contracts Act* by hiding behind legal opinion that no disclosure is required); *Twycross v Grant* (1877) 2 CPD 469 (view formed in good faith no disclosure required not a defence under the 1867 *Material Contracts Act*). For further early authority that directors are responsible for advice as to legal matters given by their lawyers in the fundraising context see *Eaglesfield v Marquis of Londonderry* (1876) 4 Ch D 693 (at 704 and 707).

See also *Heerey* (1967) at 439.

<sup>126</sup> See *Brett v Rigden* (1568) Plowd 340, 75 ER 516; *Thomas v The King* (1937) 59 CLR 279; *R v Turnbull* (1943) 44 SR (NSW) 108; *Power v Huffa* (1976) 14 SASR 337.

<sup>127</sup> *Iannella v French* [1967-8] 119 CLR 84 at 113 per Windeyer J.

question of law whether a thing or place answers a particular description in the statute.”<sup>128</sup>

A good illustration of the difficulties posed in the securities law context is demonstrated by *Von Lieven v Stewart*,<sup>129</sup> a case involving the issue of prescribed interests in contravention of the New South Wales companies legislation. The promoter of the scheme had taken legal advice and advice from officers of the Corporate Affairs Commission to the effect that there was no breach of the law and was found to honestly believe that position to be the case. The trial judge had made a finding that a mistake as to whether or not an offer of prescribed interest was issued to the public within the meaning of the legislation is a mistake of law. Handley JA considered such a bald declaration to be inappropriate having regard to the issues of mixed fact and law involved.<sup>130</sup>

Clearly this case law gives rise to troubling consequences for directors.<sup>131</sup> If the director is fully aware of all the facts underlying the legal advice and in good faith relies on the legal opinion, it is likely that that belief will be characterised as a mistake of law. On the other hand, if all the elements in the legal reasoning are not available to the director it will be easier to argue that mixed issues of fact and law are involved, entitling the director to raise the argument of mistake of fact and therefore the availability of the due diligence defence.

To be entitled to rely on a legal opinion where the director is aware of all facts will require *Shepherd v Broome* to be distinguished and an argument accepted that CA sections 731 and 733 contemplate not only mistakes of fact as well as mistakes of law to give rise to the reasonable grounds of belief required by the section. Clearly such an approach would be desirable from the policy perspective as the director should be encouraged to have regard to legal advice on difficult disclosure issues and should be protected if in good faith they rely on that advice.<sup>132</sup>

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<sup>128</sup> Ibid at 114-5 per Windeyer J. The difficulty is illustrated by the facts of *Ianella* where the court was split on the question of whether a mistaken belief that a house was subject to rent control based on newspaper reports of a change in legislation constituted a mistake of law or fact. The majority found a mistake of law. Windeyer J was in the minority.

<sup>129</sup> *Von Lieven v Stewart; Kemish v Godfrey & Anor* (1990) 21 NSWLR 52.

<sup>130</sup> Id at 67.

“Once all the relevant facts are known a mistake as to whether those facts would establish an issue, offer or invitation to the public would be a mistake of law. However all the relevant facts may not be known and there may be cases where mistakes of facts exist which, if true, would have made the conduct in question innocent.”

A final view on whether or not a mistake of law was involved was not expressed by Handley JA. On the other hand, Clarke JA considered the only mistake was “as to the legal effect of the facts known to him” and therefore a mistake of law.

<sup>131</sup> To similar effect see *Pollard v Commonwealth Director of Public Prosecutions & Anor* (1992) 8 ACSR 813 (SCNSW, Abadee J) at 830.

<sup>132</sup> In the 1992 decision of *David Securities Pty Limited & Ors v Commonwealth Bank of Australia* (1992) 175 CLR 353, the High Court found that the rule precluding recovery of money paid under a mistake of law should not form part of the law in Australia in relation to

By way of contrast to the Australian position, it is worthwhile to refer to the United States experience. Reliance on legal opinions to establish the due diligence defence has not been a feature of the prospectus liability case law.<sup>133</sup> However the academic view is generally considered to be as follows:

“if the opinion, especially of the emerging mythical figure, the independent legal counsel, finds the contested fact immaterial or not false or its omission not misleading in context, the director should be protected. You can fairly say that this effort afforded him a reasonable ground to believe in the pristine purity of the prospectus. A vaguer statement (“you need not worry about it”) probably would not absolve the director from responsibility for the misleading statement.”<sup>134</sup>

It is therefore generally considered that where the director selects a lawyer he believes to be competent, discloses all relevant facts to that legal adviser, receives advice on a particular matter of law and acts in accordance with that advice, the due diligence defence will be available if the legal conclusions reached by the legal adviser are wrong.<sup>135</sup>

The United States material stresses that in these circumstances the director reliance defence will only arise where the issue relates to a matter of law.<sup>136</sup> Where a lawyer is performing a delegated

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restitution for the recovery of money paid under a mistake. However it would be optimistic to conclude that the court’s reasoning could extend to the current context. The court focused exclusively on the policy difficulties and commentator and reform recommendations on mistake of law in the restitution context. The decision is not a general rejection of mistake of law in all contexts. To the contrary, it extends the doctrine of mistake to include mistake of law as well as fact.

<sup>133</sup> It has however been a feature of United States law in establishing compliance with a relevant standard of conduct - see *Hawes & Sherrard (1976)* at 7.

The *BarChris* Case involved consideration of a legal opinion delivered to the underwriters. The scope of the inquiries that formed the basis of that opinion were considered inadequate to establish the underwriters due diligence defence, as discussed in Section 8.3 below (*BarChris Case* at 695-7).

<sup>134</sup> *Folk 1 (1969)* at 78. For Canadian support see *Thompson (1988)* at 307-8 (citing O’Connor).

For a practical example of the establishment of the due diligence based on the delivery of a formal legal opinion see the underwriter legal opinion delivered in the *Feit Case* - see text accompanying footnote 74 of Chapter 8.

<sup>135</sup> See *Hawes & Sherrard (1976)* at 19. See also *Coffee (1977)* at 1199-1208.

For discussion of these principles in the section 11 context see *Hawes & Sherrard (1976)* at 110-126.

It is also suggested that reliance on another person’s lawyer will provide a sound basis for the defence - see *Hawes & Sherrard (1976)* at 26 - 8. This is of obvious relevance to the Australian context as outlined in Section 4.4 where legal opinions tend to be shared with the due diligence committee.

The proposed *ALI Federal Code* had contemplated specific legislative recognition of reliance on legal advice as meeting aspects of the securities laws - see Section 1704A.

<sup>136</sup> See *Hawes & Sherrard (1976)* at 30-4.

task as a finder of fact the more general principles of delegation and reliance for directors described above will apply.<sup>137</sup>

Beyond the giving of a formal legal advice on a particular disclosure issue, the Australian practice is for the lawyer to the issuer to deliver general sign-offs on the disclosures in the prospectus, the due diligence procedure adopted and each directors due diligence defence (see summary in Section 4.4). The practical limitations of the receipt of those general legal sign-offs was illustrated in the case of *NRMA v Morgan*.<sup>138</sup> In that case the lawyers had given negative assurance opinions that there was no misstatement in the disclosure document and that the directors had established their due diligence defences.<sup>139</sup> Following the Federal court finding that the disclosure document was misleading and deceptive (see Section 5.1), the lawyers were sued by the issuer, among other things, based on the alleged error in the sign-offs. The lawyers were found not to be negligent or to have engaged in misleading or deceptive conduct by giving the legal sign-offs.<sup>140</sup>

One judge (McPherson AJA in the appeal decision) said that while the giving of sign-offs increased the atmosphere of formality between the lawyers and directors, it did not significantly alter the liability position between them.<sup>141</sup> The sign-off formulation of nothing have come to the attention of the lawyer that causes it to believe the prospectus was misleading was said to be “almost meaningless”.<sup>142</sup> The lesson from the directors perspective is clearly to demonstrate that there is little to be gained from the receipt of general legal sign-off letters.

## Expertisation

As has been discussed in Chapter 4, following the enactment of the *CLERP Act*, there is no expertisation defence in the *Corporations Act*. This contrasts with the traditional position in Australia as well as the position the United States and the United Kingdom. As discussed in

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<sup>137</sup> An example of reckless reliance by directors on factual inquiries undertaken by a legal advisor is the Canadian Ontario Securities Commission decision in *Canada Cement Lafarge Limited and Standard Industries Limited* (1980) OSBC 400 discussed in *Thompson* (1988) at 297 - 8.

<sup>138</sup> *NRMA Ltd & Ors v Morgan & Ors* (1999) 31 ACSR 435 (SCNSW, Giles J). On appeal *Heydon v NRMA Ltd & Ors* (2001) 36 ACSR 462 (SCNSW, Malcolm AJA, McPherson AJA and Ormiston AJA).

<sup>139</sup> The opinions were given in the context of a due diligence committee structure of the kind described in Section 4.4 - see 31 ACSR 680-690.

<sup>140</sup> See 31 ACSR 762-3; 36 ACSR 558-9; 36 ACSR 594-5; 36 ACSR 702.

<sup>141</sup> 36 ACSR 594-5.

<sup>142</sup> In considering the negative assurance language of the signoffs, reference was made to the well known aphorism that the state of a man's mind is as much a fact as the state of his digestion.

Chapter 4, the policy basis and drafting of CA section 733 is deficient and undermines the structure of the statutory provisions.

Whether or not a specific expertisation defence is available, the analysis above illustrates that concepts of delegation and reliance are pivotal to an appreciation of the position of the director. As such, it is open to a court to find through the traditional due diligence defence or the reasonable reliance defence that where an expert provides a report for inclusion in a disclosure document, and the director is satisfied with the credibility of that expert, it is reasonable for the director to rely on the work product of that expert without extensive independent inquiries.

The United States case law outlined above suggest that the expertisation defence provides directors with a very significant safe harbour from liability where an expert is used that has a good market reputation and the director has no reason to doubt the quality of the work undertaken by the expert. In the *BarChris Case* each of the non-executive directors was entitled to rely on the expert report prepared by the issuer's auditor because of the reputation of the auditor. Judge McLean did not require that the non-executive directors investigate in any way the work product of the auditor before the defence was established. On the other hand the executive directors did not establish the expertisation defence because they did not sustain the burden of establishing they did not have actual knowledge of the relevant misstatements.

The *BarChris* court's approach to the expertisation defence has received strong academic criticism.<sup>143</sup> It has been suggested that the adoption of a wholly passive role in relation to expertised parts of the prospectus is inconsistent with requirements of reasonable investigation that are imposed on directors.<sup>144</sup> As such, any suggestion that a complete abrogation of inquiry is acceptable is argued to be inappropriate from the policy perspective. It is also argued that, in the United States context, such an approach is also inconsistent with the legislative background to the *Securities Act* of requiring care on the part of directors.<sup>145</sup>

It is suggested that a preferred standard of conduct for purposes of establishing the due diligence defence for expertised portions of the prospectus would require the director not to adopt a wholly

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<sup>143</sup> See *Folk I (1969)* at 27-9. This aspect of the *Securities Act* was amended in 1934 from a positive requirement to believe the statements of the expert to be true to a negative requirement of no reasonable grounds to believe the statements to be untrue - see *Barnett (1934)* at 10. The English formulation focused instead on the competence of the expert. Irrespective, the US standard is likely to be higher than the English standards as applied to particular statements - see *Barnett (1934)* at 11.

<sup>144</sup> Described as a "devil-may-care" approach by Professor Folk - see *Folk I (1969)* at 28.

<sup>145</sup> See *Folk I (1969)* at 28 referring to the conference reports relating to the formulation of the 1934 amendments to the *Securities Act* 1933 that resulted in the current formulation of the defence. The previous *CL* regime was criticised in the *Loneragan Committee Report* for the same reason - at paragraph 98. Canada is likely to require a higher standard - see *Thompson (1988)* at 283 and 295.

passive role, but through general inquiries satisfy themselves that the expertised statements in the prospectus are reliable having regard to the general standard of conduct for directors outlined above.<sup>146</sup>

From a policy perspective, the *BarChris Case* can be faulted for the lenience with which the non-executive directors in question were treated in relation to expertisation. It is relevant, of course, that irrespective of the finding of the court on the expertisation defence the directors there faced full liability for the misstatements in the non-expertised portions of the prospectus. As such, the court finding on this issue were not crucial to the outcome of the case.

In the Australian context a stricter approach should be preferred from the policy perspective to the *BarChris Case* approach.<sup>147</sup>

#### 7.4 THE POSITION OF MANAGEMENT

The position of management would appear to have been overlooked in formulating the requirements of Part 6D.3 of the *Corporations Act*. While the position of management, particularly executive management, is pivotal to the process of preparation of a prospectus they would not appear to be explicitly dealt with at all.<sup>148</sup>

##### Can Management Have Primary Liability?

While management is not explicitly dealt with in the statutory regime, it may be that a theory of liability can be developed to deem a member of management to have primary civil liability for a prospectus misstatement in certain circumstances. There are two potential theories that could be developed in an attempt to hold management primarily liable for a prospectus misstatement under the civil liability provisions of Section 729 of the *CA*:

- management as de-facto directors; or
- management as named and responsible for making a statement within the meaning of the legislation.

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<sup>146</sup> *Folk I (1969)* at 28.

<sup>147</sup> In 1945 the Cohen committee had recommended that the expertisation defence of the *1890 Directors Liability Act* be tightened by reversing the onus of proof so that it should be a matter for the defendant to establish that he had reasonable grounds for relying on the work of the expert.

That approach might be supported by the above analysis. The recommendation was not subsequently acted upon.

The first potential approach would be to argue that some members of management come within the definition of directors as used in the *Corporations Act*. The CA section 9 definition of director encompasses persons “in accordance with whose directions or instructions the directors are accustomed to act” as well as persons occupying a director’s position whether appointed or not and by whatever name called. Until recently these provisions had not been the subject of judicial attention.<sup>149</sup> The cases illustrate that the issue is basically a question of fact and actual dominance of the company’s decision making processes is required to be demonstrated before a deemed director finding will be made. Generally, an executive that is delegated responsibility for certain management functions by a properly operating board will not demonstrate a relationship of sufficient dominance to satisfy the statutory definition.<sup>150</sup>

The second approach is to argue that management are named in a disclosure document and have made a statement included in the disclosure document or on which a statement included in the disclosure document is based.<sup>151</sup>

It is a practical necessity in most prospectuses that, in addition to identifying the board of directors, an organisational chart or list of key management is contained in the prospectus so that investors have some comfort as to the key persons who are responsible for the conduct of business of the issuer. It can therefore be argued that the member of management will have been named in the prospectus with their consent.

The question will therefore be whether the member of management has made a statement that is included in the disclosure document or has made a statement on which a statement based on the disclosure document is based. The analysis in Chapter 9 will apply equally to management in this situation.

On the whole, the theories of liability outlined above are very weak and unlikely to sheet primary liability home to a member of management.

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<sup>148</sup> See J Jackson “*The Liability of Executive Officers Under the Corporations Law*” (1991) 3 Bond L Rev 275.

<sup>149</sup> See now *Standard Chartered Bank of Australia Ltd v Antico & Ors* (1995) 18 ACSR 1 (Sup Ct NSW, Hodgson J) at 65-71; *Dairy Containers Ltd v NZI Bank Ltd* [1995] 2 NZLR 30 (HC, Thomas J) at 90-1; *Kuwait Asia Bank v National Mutual Life Nominees Ltd* [1991] 1 AC 187 at 223-4. Each of these cases involve a situation where a substantial shareholder of a company with nominee directors was argued to be a deemed director of the company.

<sup>150</sup> Cases on when persons take part in management of a company for purposes of liability under Part 5.7B of the *Corporations Act* (insolvent trading) also demonstrate this approach by requiring a finding of actual significance in the company’s decision making process: See *Re New World Alliance Pty Ltd (Rec & Mgr Apptd)*; *Sycotex Pty Ltd v Baseler & Ors* (1994) 122 ALR 531 (FCA, Gummow J) at 547 (company secretary not such a person); *Taylor & Anor v Darke* (1992) 10 ACLC 1516 (FCA, Beaumont J) at 1522 (senior management was such a person); *Holpitt Pty Ltd v Swaab & Ors* (1992) 33 FCR 474 (FCA, Burchett J) at 477-8 (solicitor/company secretary not such a person).

A more direct route to liability against members of management would be reliance on the miscellaneous offences provision of Part 9.4 of the *Corporations Act*. As noted in section 5.2, section 1309 of the *Corporations Act* imposes potential liability on “officers” who make available or furnish information (or authorise or permit the making available or furnishing of information) to directors or members that is either known to be false or where there is failure to take reasonable steps to ensure the information does not contain a misstatement.<sup>152</sup>

For these purposes an officer is defined in the *Corporations Act* to only include persons who make decisions that effect the whole or a substantial part of the business or who have the capacity to significantly affect the financial standing of the corporation.<sup>153</sup> The courts have considered that this definition means that only senior members of management will face potential liability.<sup>154</sup>

This potential remedy will be useful to ASIC in considering a criminal prosecution if, as a result of investigations, it is clear that a member of management has had a degree of responsibility for a prospectus misstatement. On the other hand, as a potential civil remedy for an investor the opportunity is much more limited because of the threshold difficulty in establishing what the role of a member of management has been in the prospectus preparation process.

It is also likely the case that the use of the term “officer” is too restricting in the capital raising context. A broader definition that captures the members of senior management involved in the capital raising process would be more desirable from the policy perspective.

### Accessory Liability

Notwithstanding the ambiguity of the above analysis as it relates to primary civil liability, members of management involved in the prospectus preparation process will face potential liability for particular statements in a disclosure document on the basis of accessory liability under the *Corporations Act*.<sup>155</sup>

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<sup>151</sup> CA section 729(1), Item 5.

<sup>152</sup> Section 1308(1) and (2).

<sup>153</sup> The definition of officer in the *Corporations Act* extends to directors and persons who make or participate in making decisions that affect the whole or a substantial part of the business of the corporation, who have the capacity to affect significantly the corporation’s financial standing or in accordance with those instructions or wishes the directors of the corporation are accustomed to act (section 9).

<sup>154</sup> See for example *Commissioner for Corporate Affairs (Vic) v Bracht* (1988) 14 ACLR 728 (SC Vic, Ormiston J) (following cases such as *R v Newth* [1974] 2 NZLR 760; *R v Campbell* (1984) 88 Cr App R 95; *Re A Company* [1980] Ch 138).

<sup>155</sup> CA section 728(3) (criminal) and section 729(1), Item 6 and section 79 (civil).

The due diligence and reasonable reliance defences are available in relation to that potential liability, as outlined in Chapter 9.

Accessory liability is predicated on a showing of knowledge and a degree of participation in the contravention in question. As such, again the remedy will be useful in a criminal prosecution where an investigation makes it clear that a member of management has had a degree of responsibility for a prospectus misstatement but less useful as a potential civil remedy for an investor because of the threshold difficulty of establishing what the role of a member of management has been in the prospectus preparation process.

### A Comparison with the United States

In assessing the position of management it is useful to contrast the United States experience.

In the United States all persons who “signed the registration statement” are responsible for a misstatement under section 11(a)(1) of the *Securities Act* 1933. A registration statement must be signed, among others, by:

“its principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer ... or persons performing similar functions.”<sup>156</sup>

As such, all members of senior management face the same primary liability as the directors of the issuer.

The *BarChris Case* demonstrates a situation where a member of management, who was not a director, had signed a registration statement. In relation to the executive directors Judge McLean had considered the responsibility of the executive within the organisation as well as their actual skills in considering the availability of the due diligence defences. All of those executive directors were members of the executive management that exercised day to day management control and the judge was not prepared as a preliminary finding of fact that they could have believed in the truth of the statements in question. On the other hand, the company secretary was able to establish the due diligence defence in relation to the expertised financial statements as he had no personal knowledge of the issuer’s financial statements.<sup>157</sup>

In relation to the executive that was not a director, Judge McLean similarly looked at the responsibilities of the person in question and his role in prospectus preparation. The officer was a

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<sup>156</sup> Section 6(a) of the *Securities Act* 1933.

<sup>157</sup> See discussion at notes 69 and 70 above. Note that on the analysis of the case inquiry is still required for areas outside the area of responsibility of such a person to establish the defence (ie, ignorance is no defence).

financial controller who had a comparatively limited involvement in the business of the issuer and was not an executive officer or a member of the executive committee that had primary responsibility for managing the business of the issuer. He was not named in the management description of the issuer in the prospectus.<sup>158</sup>

The due diligence defence was not established by the controller as to the non-expertised portions of the prospectus because it was found he had actual knowledge of at least one of the misstatements. In addition the expertisation defence was not established in relation to the audited accounts of the issuer because his area of responsibility for the issuer extended to general knowledge of the issuer's financial position.

The approach of the court was to treat the controller as essentially being in the same position as the inside directors.<sup>159</sup>

In the *Feit Case*, as discussed above, the position of insiders was further elevated through the comment that the liability position approaches that of guarantor of the accuracy of the prospectus.<sup>160</sup>

In the United States, officers who do not sign the registration statement do not face liability under section 11 or under the accessorial liability provisions of the securities laws.<sup>161</sup>

The point has been made above that in the director context that there may be a different approach by Australian courts as compared to United States as to the formulation of the standard of conduct required to establish a due diligence defence.<sup>162</sup> However, it can be expected that the general sentiments expressed in the United States would find their corollary in any Australian case dealing with the application of a due diligence or reasonable reliance defence to a member of management.

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<sup>158</sup> *BarChris Case* at 686 (the controller's name was Trilling).

<sup>159</sup> See analysis at *Folk 1 (1969)* at 25-6.

<sup>160</sup> See text at note 75. It has been suggested that the case law makes it impossible for corporate insiders to conduct a legally sufficient due diligence investigation in the face of a material inaccuracy in a prospectus, to the point that "omniscience is virtually presumed and omniscience is required" - *Spanner (1988)* at 127.

<sup>161</sup> See *Bresson v Thomson McKinnon Securities, Inc.* 641 F Supp 1465 (D Or, 1986); *Ahern v Gaussion* 611 F Supp 1465 (D Or, 1985); *McFarland v Memorex Corp* 493 F Supp 631 (ND Cal, 1980). *Folk 1 (1969)* makes the point that there is a level of unfairness in the fairly artificial designation of the persons who assume liability under these provisions based purely on the persons who sign the document (especially for less senior management) - see at 26.

<sup>162</sup> See text at notes 96 to 105 in Section 7.3

### Should There Be Liability?

Having regard to the above analysis, the policy issue arises as to whether management should face liability for prospectus misstatement. It is clear that that is a debate that can be resolved quickly, particularly in the case of senior management.

Senior management have a role in the prospectus preparation process that is as important as the position of the director. Ultimately senior management are responsible for the accuracy of information contained in the prospectus for those parts of the business of the issuer for which they have been delegated responsibility by the board of directors. It has been suggested that management have a strong temptation to engage in a public offering at a high price so as to hold onto their jobs.<sup>163</sup> It can be expected that this temptation is much stronger than for the professional company director who is less financially linked to any one company of which she is a director and who is likely to be strongly deterred through the general community perception as to the potential liability that attaches to the work of a director. As such, deterrence is clearly served by the direct imposition of liability on senior management.

Further, orthodox corporations theory would suggest that the imposition of potential primary liability on senior management is sound as a matter of policy.<sup>164</sup> Modern corporations theory acknowledges that directors are unable to manage corporations in any narrow interpretation of those words and it is the senior executives that practically manage the business.<sup>165</sup> The recent case law on the duty of care, skill and diligence, particularly in relation to non-executive directors, illustrates the practical necessity of reliance and delegation in the modern corporation.

Finally, management liability is clearly justified from the perspective of “gatekeeper” liability. Clearly management are a key gatekeeper of the accuracy of information contained in fundraising disclosure documents.

Against that background it is odd that the position of management was not addressed in any of the reviews at the Australian fundraising provisions, from the work of the SIRC committee

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<sup>163</sup> See M. Gulati “*When Corporate Managers Fear A Good Thing is Coming to an End: The Case of Interim Non-Disclosure*” (1999) 46 UCLA L Rev 675 at 696 - 709 and *Langevoort* (2000) at 63.

<sup>164</sup> See particularly A. Berle & G. Means “*The Modern Corporation and Private Property*” (1933) in this regard.

<sup>165</sup> M.A. Eisenberg “*Legal Models of Management Structure in the Modern Corporation: Officers, Directors and Accountants*” (1975) Cal L Rev 375 at 376.

through to the background materials of the *CLERP Act*. Policy analysis, as well as comparative analysis, should have identified this as an issue that merited attention.<sup>166</sup>

In the context of judicial recognition of the significance of reliance and delegation it follows that the integrity of prospectus disclosure is enhanced by imposing specific liability on the persons responsible for acting as the link between the board and its advisors on the one hand, and the business of the issuer. A strong case can therefore be made for the provisions of Part 6D.3 to deal explicitly with senior management.

It can, of course, be argued that the general principles of accessory liability as well as section 1308 of the *Corporations Act* is sufficient to encompass the position of management. However, the legislative scheme would be enhanced by dealing clearly with the position of each key gatekeeper in the primary provisions. Further, the secondary remedies have the issues outlined above. For that reason a strong case can be made for the provisions of Part 6D.3 to deal explicitly with senior management.

## 7.5 THE POSITION OF THE ISSUER

Historically the sanctions for prospectus misstatement did not impose liability on the issuer itself. The 1861 *Larceny Act* targeted criminal liability on directors. The 1890 *Directors Liability Act* targeted directors. The *Corporations Law* as originally enacted imposed specific civil liability on the issuer for the first time without explaining its purpose in doing so. The *CLERP Act* extended the scope of liability of the issuer to both the criminal and civil remedies.

The issuer or seller of securities potentially has available to it the due diligence defence and reasonable reliance defence of the *Corporations Act* as it is clearly expressed that these defences are potentially available to all persons who face criminal or civil liability under the legislation.

In the case of the reasonable reliance defence, the defence for a body excludes reliance on a “director, employee or agent” of the body.<sup>167</sup> The Explanatory Memorandum to the *CLERP Bill* suggested that this has the effect of a body being unable to rely on its own information but that

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<sup>166</sup> A historical oddity is that the original liability provision, the 1867 *Material Contracts Act* (copied, among other places, in section 66 of the *Companies Act 1899* New South Wales) imposed liability on “officers” as well as directors. That approach was not followed in any of the later legislation. See text in footnote 67 in Chapter 1.

<sup>167</sup> CA section 733(1)(a).

the body will be able to carry out due diligence through its officers and employees for the purpose of establishing its due diligence defence.<sup>168</sup>

The qualification to the reasonable reliance defence has the result that the corporate issuer of securities will be most unlikely to rely on information provided by others. The issuer will typically authorise the conduct of due diligence inquiries through its officers. The issuer cannot rely on information provided by “employees”. The issuer will be responsible for appointing various advisors (accountants, lawyers and the brokers) who will conduct due diligence inquiries as part of the due diligence committee. As the issuer appoints those persons and pays them, the advisors will clearly be “agents” of the issuer with the result that the issuer cannot rely on that information. It would be the exception rather than the rule where information is relied upon by an issuer without an employee or agent relationship.<sup>169</sup>

In this regard, the reasonable reliance defence was the subject of general criticism above for its failure to appropriately address the process of prospectus preparation.<sup>170</sup> The position of the issuer is the most extreme example of the difficulties created by the drafting of the reasonable reliance defence.

As such, and as suggested by the Explanatory Memorandum to the *CLERP Bill*, the issuer must turn to the traditional due diligence defence of section 731 for a meaningful defence. The difficulty with that defence is that it was originally created by the *1890 Directors Liability Act* as a defence to individual liability, not a corporate entity.

In order to establish the due diligence defence, the issuer must “believe” on “reasonable grounds” in the facts of the statements. In the case of an issuer, the question becomes whether general principles of corporate responsibility based on the knowledge of its board apply to this determination,<sup>171</sup> or alternatively whether some broader principles of knowledge based on the entity as a whole, should apply.

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<sup>168</sup> *Explanatory Memorandum to the CLERP Bill* - paragraph 8.40.

<sup>169</sup> An example where it would apply is the incorporation into the disclosure document of industry information provided by industry or government bodies. Another example would be information included in a disclosure document prepared by a ratings agency (ratings agencies are not retained by corporates in the traditional sense of agency).

<sup>170</sup> See text at footnotes 49 to 51 of Chapter 4.

<sup>171</sup> Applying the well known principles reflected in *Tesco Supermarkets Ltd v Natrass* [1972] AC 153.

If the former principles apply, it may be that an issuer has a good prospect of making out a due diligence defence, if its directors are able to make out the due diligence defence in relation to their own position.

On the other hand, if the position of the issuer was equated with the knowledge of its management and the sentiment of the United States case law described above as it applies to corporate insiders was to be applied derivatively to the issuer there would not be a high likelihood that the issuer, should be able to establish the due diligence defence.

This issue is left entirely unclear by the legislation. The net result is that the scope of the reasonable reliance defence is very limited while the scope of the traditional due diligence is quite uncertain.

### **A comparison with the United States**

In the United States the issuer is specifically excluded from being able to rely on the due diligence defences in section 11 of the *Securities Act* 1933. The issuer therefore has strict liability if a material misstatement is established.<sup>172</sup> This follows from the intent of the *Securities Act* that there be a reversal of the principle of caveat emptor to the proposition that the seller also beware in the prospectus offering process.<sup>173</sup>

The issuer has therefore been described as having liability that is “virtually absolute”.<sup>174</sup> This aspect of the United States regime results in a perception that section 11 liability as it applies to the issuer is the most burdensome provision of the United States securities laws.

### **Policy Analysis**

The issue that arises is whether or not it is desirable to impose liability on the issuer from the policy perspective.

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<sup>172</sup> The only defences available to the issuer is that the purchaser knew of the misstatement, that the purchaser fails to establish reliance where there is a subsequent earnings statement or that the damages resulted from factors other than the misstatement -see *Folk I* (1969) at 19 (footnote 119).

<sup>173</sup> Paraphrasing the well known speech of President Roosevelt at 77 Cong Rec 2918 (1933) discussed at text accompanying footnote 108 of Chapter 1.

<sup>174</sup> See *Herman & Maclean v Huddleston et al* 459 US 375 (1982) at 382; *Bernstein v Crazy Eddie, Inc* 702 F Supp 962 (EDNY 1988) at 973.

In relation to criminal liability, the policy issues associated with imposing corporate criminality on the issuer have already been noted in Section 2.1.<sup>175</sup> Those issues were not addressed or discussed in the background materials to the *CLERP Act*.

Difficult issues also arise from the perspective of civil liability. While the United States approach has some attraction at a cursory level, such a sentiment is not necessarily consistent with a policy of deterrence underlying the prospectus liability regime, in that absolute liability that cannot be mitigated against does not encourage the taking of care. As such, the United States position might be considered as more a reflection of the political sentiment at the time the *Securities Act* 1933 was introduced rather than as establishing an appropriate regime in Australia.<sup>176</sup>

A countervailing consideration to this conclusion arises from addressing the question of whose benefit the imposition of civil liability against the issuer advances. The award of damages against an issuer causes a value shift from the then shareholders of the issuer to those who are entitled to claim damages for the prospectus misstatement. There is a respectable argument that, having regard to this value shift, it is not appropriate that there be civil liability for prospectus misstatement against issuers.<sup>177</sup> This is because the damages award simply harms the remaining shareholders of the company and does not advance any in terrorem policy of the legislation.

A comparative analysis with Commonwealth jurisdictions does not yield any helpful material. As noted above, historically liability was not imposed on the issuer itself. This would seem to have been reflective of the common law principle developed in *Houldsworth v City of Glasgow Bank*<sup>178</sup> that a remedy in deceit was not available unless the contract for allotment of securities had been rescinded. In most jurisdictions the result of recent developments is that issuer would seem to have primary liability and the potential availability of a traditional due diligence defence, with the same ambiguities that arise in Australia.<sup>179</sup>

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<sup>175</sup> See text accompanying footnote 40 of Chapter 2.

<sup>176</sup> In a practical sense the concern that deterrence be furthered is advanced by the fact the directors of the issuer, as the guiding mind of the issuer, are incentivised to take care through their personal position and the availability of the due diligence defence to them.

For discussion of the continuing appropriateness in the United States see *Langevoort (2000)* at 64. Langevoort suggests that absolute liability is justified from the policy perspective where the deception was the fault of someone in the organisation and therefore could have been prevented or detected.

<sup>177</sup> See *Cohen (1966)* at 1370.

<sup>178</sup> (1880) 5 AC 317.

<sup>179</sup> In the United Kingdom the issuer is responsible for the disclosure document and faces potential civil liability as a responsible person (see paragraph 6(1)(a) of the *Financial Services and Markets Act 2000 (Official Listing of Securities) Regulations 2001* and regulation 13(1) and regulation 14(1) of *The Public Offers and Securities Regulations 1995*). For discussion see *Hofler (1995)* at 68-9; S. Griffin "Damages for Misstatements in Company Prospectuses" (1991) *Comp Law* 209 at 210.

This debate leaves a confusing issue for resolution by the legislation. The enactment of the *Corporations Law* and the *CLERP Act* did not involve any policy analysis or apparent recognition of any of these issues. A default position was adopted which apparently places the issuer in the same position as other defendants. However, the above analysis illustrates a much more ambiguous analysis as applied to the issuer as compared to other participants involved in the capital raising process. The ambiguity is reflective of the failure to clearly espouse a policy basis for imposing liability on the issuer (notwithstanding the comments made in the Explanatory Memorandum to the *CLERP Bill*).

## CHAPTER 8

### UNDERWRITER LIABILITY

From the perspective of the underwriter the enactment of the *Corporations Law* was significant in that it represented the first Australian legislation to specifically impose potential civil liability for prospectus misstatement on the underwriter/stockbroker as a participant in the capital raising process.<sup>1</sup> This development is consistent with the structure of the securities laws in many key overseas jurisdictions.

This chapter considers the liability position of underwriters and stockbrokers under the Australian regime.<sup>2</sup>

#### 8.1 POLICY RATIONALE FOR UNDERWRITER LIABILITY

The imposition of potential liability on underwriters and stockbrokers is clearly reasonable as a matter of policy in that it recognises the critical role played by underwriters and stockbrokers in the capital raising process. In assessing the effectiveness of the *Corporations Act* provisions as they apply to underwriters and stockbrokers it is worthwhile to clearly delineate the policy basis for this proposition.

##### Role of the Underwriter

The role of the underwriter in Australian capital raising involves at least three economic functions.<sup>3</sup>

At the simplest level underwriters and stockbrokers perform a professional advisory role for issuers (the “advisory” role). The underwriter or stockbroker advises potential issuers on the capital raising process and the pricing of an issue. In this capacity the role of the underwriter or stockbroker is analogous to other professionals such as the lawyer or the accountant. The underwriter will have experience in the capital raising process and will sell that expertise to issuers.

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<sup>1</sup> Underwriter liability had been proposed in the *Corporations and Securities Industry Bill* 1974 but that proposal was not acted on in the formulation of the *Companies Code* 1981. The *SIRC Report* had similarly endorsed underwriter liability.

<sup>2</sup> Many of the issues addressed in this chapter are also dealt with in the *Golding (1993)* article (based on the pre-*CLERP Act* position).

<sup>3</sup> For similar analysis in the United States context see *Dooley (1972)* at 784-792; *Langevoort (1985)* at 752.

In addition, stockbrokers act as sale intermediaries on behalf of issuers. The stockbroker will locate potential investors and sell securities to these investors (this is the “stockbroking” role). Traditionally in Australia stockbroking houses maintain long term relationships with retail investors.<sup>4</sup> By becoming associated with a stockbroker, the issuer will gain access to that retail client base. Alternatively, the stockbroker will undertake selling activities in the market with professional investors and approach further retail investors on behalf of the issuer.

Finally, underwriters (but not stockbrokers) assume risk (this is the “underwriting” role). The underwriter will underwrite the risk of a shortfall in investor demand arising and subscribe for any securities that have not been subscribed for by investors. It is this third function that provides the critical distinction between the role of a “stockbroker” and the role of an “underwriter”. For convenience, in the following analysis the term underwriter will generally be used to describe both underwriters and stockbrokers.

The professional advisory role and intermediary role performed by Australian underwriters and stockbrokers is similar to the practice in other countries. However there are some differences in underwriting practice in Australia in relation to the assumption of risk as compared with other countries.

In Australia the traditional approach was that securities are offered to the market at a fixed price arrived at by agreement of the issuer and the underwriter. At the time the prospectus is lodged with ASIC an underwriting agreement is signed. The underwriter will agree that at the end of the offering period it will subscribe for any shortfall shares, being shares for which investors have not lodged applications. The offer period will be a period of some weeks and during this period the underwriter will be committed to subscribe for shortfall shares subject to no “underwriting outs”, as provided for in the underwriting agreement, having occurred. An “underwriting out” is a condition contained in the underwriting agreement specifying an event that, if it occurs, will permit the underwriter to terminate its obligation to subscribe for any shortfall shares.<sup>5</sup>

During the committed period (which may extend for a considerable time), the underwriter will bear the risk that applications are not received for the shares offered. This poses difficulty for

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<sup>4</sup> This is the so-called “private client” lists of brokers.

<sup>5</sup> Typical underwriting “outs” include assurances that the prospectus remains accurate (no false or misleading statement or omission, no stop order or inquiry into the prospectus initiated by ASIC, and no supplementary prospectuses are lodged), no material adverse change concerning the issuer, no market changes (stock market index does not drop by more than a specified percent) and no declaration of war or outbreak of hostilities concerning specified countries.

underwriters in volatile markets as, if the market falls the underwriter may face a shortfall, while if the market rises the issuer might not have maximised its return from the offering.

With volatile and, in some cases, rapidly rising markets in the 1990s the Australian market has moved to more flexible pricing methods such as constrained open pricing<sup>6</sup> and open pricing.<sup>7</sup> In these types of offering, the final price set for the offering is largely determined by institutional interest<sup>8</sup> with retail investors participating through invitations to invest at a predetermined price.<sup>9</sup>

Under these pricing methods, the underwriter will typically only act as broker and will not underwrite the subscription by investors of any part of the offering.

A very different system has traditionally operated in the United States.<sup>10</sup> Under this system the initial prospectus is distributed with a blank in the prospectus for the price at which the securities will be offered.<sup>11</sup> Potential investors are then approached to determine their interest in the offering and a price is determined by the underwriter through negotiations with the issuer based on the indicative demand of the investors approached. At the time the price is fixed the underwriter will enter into an underwriting agreement with the issuer to purchase all of the securities from the issuer.<sup>12</sup> The underwriter immediately on-sells the securities to the investors who have indicated an interest in acquiring the securities at the agreed final price.<sup>13</sup> The investors approached will be institutional investors and clients of the underwriter. This procedure differs from Australia where in many cases the securities will be offered to the general public through public advertisement whether or not the investors have a pre-existing relationship with the

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<sup>6</sup> Constrained open pricing is where the issue price is set in a nominated range at the end of the offer, with demand for the issue determining the final price set.

<sup>7</sup> Open pricing does not contemplate a range of final prices (although an indicative price range may be set for reference purposes).

<sup>8</sup> Institutional support is determined by a bookbuild where institutional investors bid based on price, volume or a combination in transactions that are technically exempt from the requirement to lodge a disclosure document under Chapter 6D (section 708).

<sup>9</sup> This price will normally represent a cap on the price retail investors will have to pay, with a refund if the final price is lower.

<sup>10</sup> For a description, see for example the detailed description in *Allen (1991)* and see *Freund & Hacker (1974)* at 464 - 7. A history of the US practice is set out at *Loss & Seligman (1994)* at 55 - 72. For a comparison between the US and England (similar to Australia) see *Gleeson & Bloomenthal (1999)* at 362-366.

<sup>11</sup> The so called "red herring" prospectus.

<sup>12</sup> Subject to underwriting outs similar to those described above used for Australian purposes. This form of underwriting is known as a "bought deal" because the underwriter has subscribed for the entire issue.

<sup>13</sup> The difference between the price paid by the underwriter to the issuer and the price paid by the investor to the underwriter (the "spread") will represent the underwriters' fee.

underwriter. In the United States a deeper market of potential investors is established through the formation of underwriting syndicates, rather than through public advertising of the offering.<sup>14</sup>

As the underwriter will only sign the underwriting agreement if it is satisfied that it has onsold the issue, the underwriter's commitment represents an underwriting of settlement risk<sup>15</sup> rather than an underwriting of investor support and the underwriting is only for the period of time required to effect settlement.<sup>16</sup> Following pricing, all investors who have been allocated securities will be issued a final prospectus with the final price incorporated in the final prospectus. The process takes place in accordance with the registration statement lodged with the SEC, with the registration statement covering the entire distribution process and incorporating the red herring and the final prospectus.

The 1990s Australian development of open pricing techniques largely reflects an attempt to move to the United States system, with changes to reflect the Australian regulatory system.<sup>17</sup> This has also been the experience in other securities markets, such as the United Kingdom and New Zealand. Canada had followed the United States approach to underwriting for some time as a result of the physical proximity of their markets.

New technology may have the effect of reducing the significance of the position of the underwriter and leading to issuers dealing directly with investors so to fix prices and attend to the distribution of securities.<sup>18</sup> However, the advisory role and the stockbroking role described above and the ongoing relationship between underwriter and investor suggests that the significance of the role of the underwriter in the capital raising process will be difficult to break.<sup>19</sup>

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<sup>14</sup> For a description see *Freund & Hacker (1974)*; *Klinges (1985)* at 1065-9.

<sup>15</sup> That is that the investor to whom the underwriter has simultaneously onsold will not settle that transaction.

<sup>16</sup> However, the underwriter is technically performing the underwriting function described above during this period.

<sup>17</sup> The differences reflect differences between the lodgement requirements of the *Securities Act* and Chapter 6D of the *Corporations Act* (and Part 7.11 before it) as well as other local issues such as stamp duty considerations (which might impose stamp duty on an underwriter taking securities as a bought deal and then onselling to investors).

<sup>18</sup> In the United States other reasons over the last two decades may be changes in the registration system through the facilitation of shelf registration, leading to an acceleration from relationship to transactional investment banking - see *Langevoort (1985)* at 754 - 764; *McLaughlin (1993)* at 63-9.

<sup>19</sup> For support of the proposition that in the current milieu underwriters, or more particularly "prestigious" underwriters, enhance the prospects of a successful offering see *Ferris et al (1992)*.

### Reasons to Impose Liability

Consideration of the role performed by the underwriter in the Australian capital raising process suggests that the imposition of potential liability on the underwriter is reasonable from the policy perspective. In that regard the underwriter is the key gatekeeper involved in the prospectus preparation process.

Through the intermediary role described above, the primary selling effort is undertaken by the underwriter. The underwriter will rely on representations and information provided by the issuer in making statements to potential investors as to the financial position and prospects of the issuer. This reliance on information provided by the issuer and the fact that the underwriter is acting as representative of the issuer might suggest that it is inappropriate to impose liability on the underwriter. However the investing public is entitled to expect high standards of conduct from underwriters, as it is the underwriter that will deal with the investor and will be the primary source for the dissemination of information concerning the offering.

The imposition of liability on the underwriter is therefore consistent with a deterrent focus to the civil liability provisions of the prospectus laws. Underwriter liability had been imposed for the first time in the United States in 1933, reflecting public anger and a perception that underwriters (in particular) had perpetrated frauds on the investing public in the 1920s.<sup>20</sup> While that public indignation has not been felt so acutely in any other jurisdiction (or perhaps since then in the United States), the basic policy rationale for underwriter liability remains applicable to the debate in Australia.

Underwriter liability can be supported on a number of grounds because the underwriter, of all the persons involved in the capital raising process, is in a unique position to ensure the accuracy of disclosure in the prospectus. A number of reasons are frequently presented for that view.

*Risk/Reward:* First, the issuer involved in a single offering may find that the rewards to be gained from a capital raising far outweigh any potential risk of civil liability. On the other hand,

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<sup>20</sup> Refer to the analysis in Section 1.4. This was one of the key reasons for the imposition of underwriters liability in the United States following the 1929 crash and is illustrated by the following quote from a house report on the 1929 crash in 1933:

“During the post-decade some 50 billions of new securities were floated in the United States. Fully half or \$25,000,000,000 worth of securities floated during this period have been proved to be worthless ... The floatation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest and prudent dealing that should be basic to the encouragement of investment in any enterprise” (HR Rep No 85 73d Long 1st Sess 2 (1933) - see *Scott (1986)* at 235.

the underwriter is involved in the business of capital raising and therefore has much less to gain by taking a one-off risk in relation to disclosure for a particular offering.<sup>21</sup>

As such, the imposition of potential liability on the underwriter if care is not taken acts to counterbalance the temptation the issuer (and, in particular, its executives) might otherwise feel in relation to sensitive disclosure issues.

*Independence:* Second, the underwriter is the most independent person who is in a position to investigate the proposed offering.<sup>22</sup> Unlike the underwriter, the lawyers, accountants and other advisors do not generally engage in an overall review of all aspects of the issue.<sup>23</sup> It is only the underwriter that is retained by the issuer to provide an overall review of all disclosure issues from a commercial perspective.

As such, it is appropriate that care should be expected of the underwriter in relation to the prospectus generally.

*Skills:* Third, the underwriter will be best able to investigate and verify the statements in the prospectus.<sup>24</sup> An underwriter will have experience in the pitfalls associated with capital raising and will have the resources available to undertake a detailed review of the prospectus disclosures. The underwriter will be compensated by the issuer for the use of those resources.

As such, it is appropriate that the legislation be tilted in favour of requiring an issuer to use the resources of the underwriter in the interests of higher quality offering documents.<sup>25</sup> Of course, that argument is based on the premise that the benefits of higher quality offering documents outweigh the additional costs of underwriter scrutiny. It can be argued that it is consistent with concepts of market efficiency to impose the costs of certification on underwriters (and therefore

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<sup>21</sup> See Comment “*BarChris: Due Diligence Refined*” (1968) Colum L. Rev 1411 at 1421; *Fox* (1984) at note 5.

On the other hand it has been argued that in large corporations (as most investment banks are) decisions tend not to be made rationally in calculating the trade-off between short-term gain and the increased risk of future liability - see C.Stone “*The Place of Enterprise Liability in the Control of Corporate Conduct*” (1980) 90 Yale LJ 1 at 19-24. In the case of underwriters it can be argued that this is aggravated by the performance based remuneration structure that is adopted for the executives promoting the offering.

Notwithstanding this comment, the general point remains valid.

<sup>22</sup> See *Nicholas* (1983) at 11; *Ferris et al* (1992) at 583-4.

<sup>23</sup> As reflected by the liability position discussed in Chapter 9.

<sup>24</sup> See *Chris-Craft Industries Inc v Piper Aircraft Corp* 480 F 2d 341 (1973) at 370; *Folk I* (1969) at 54; *Scott* (1986) at 242.

<sup>25</sup> This is the effect of approach of precedent such as *In the Matter of Richmond Corp* 41 SEC 398 (1963) discussed below. See also *Folk I* (1969) at 54.

issuers) so as to reduce the duplication of search costs that might otherwise be imposed upon potential investors.<sup>26</sup>

The reduced involvement of regulatory scrutiny by ASIC as contrasted with the previous regime in the Australian capital raising process can be argued to provide further support for the need for the underwriter to perform such a role.

*Reputation:* Fourth, investors and their professional advisors generally consider that by being associated with an issue a reputable underwriter will implicitly vouch for the issue and represent that it is an appropriate investment for its clients.<sup>27</sup> As such, principles of gatekeeper liability suggest that it is appropriate to impose liability on the underwriter as a reputational intermediary.<sup>28</sup>

As such, investors and their professional advisors will expect that the underwriter will have undertaken such inquiries as are necessary to satisfy itself that disclosures in the prospectus are appropriate.

*Influence:* Finally, the underwriter has the capacity to impose its will on the issuer to ensure the accuracy of disclosure.<sup>29</sup> The offering will not normally proceed if the underwriter refuses to enter the underwriting agreement.

If the underwriter withdraws from the offering because of dissatisfaction with disclosure that will likely have a negative impact on the ability of the issuer to seek an alternative underwriter, particularly in a capital market as small as Australia's. The withdrawal of an accountant or other advisor is unlikely to be as damaging as the withdrawal of the underwriter from this perspective.

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<sup>26</sup> See the debate in Section 1.6.

In *Gilson & Kraakman (1984)* at 618 and 620 it is argued that the role of underwriter as "information and reputational intermediary" is of pivotal importance in the capital raising process. The investment banker "rents" the issuer its reputation and represents to the market that it has evaluated the issuer's product in good faith. This role is argued to increase the efficiency of the capital markets as the cost of information is reduced, information is more widely distributed and is more effectively reflected in market price. It is suggested by *Gilson & Kraakman* that a more traditional concept of "fairness" in relation to misstatements would not impose primary liability on the underwriter. See also *Ferris et al (1992)* at 585-6.

<sup>27</sup> See *BarChris Case* at 696; *Chris-Craft Industries Inc v Piper Aircraft Corp* 480 F 2nd 341 (1973) at 370; *In the Matter of Richmond Corp* 41 SEC 398 (1963) at 406; *Folk I (1969)* at 54; *Scott (1986)* at 223; Carney "The Limits of the Fraud on the Market Doctrine" (1989) 44 Bus Law 1259 at 1288-9; *Ferris et al (1992)* at 583-4; *Coffee (1997)* at text accompanying note 27.

<sup>28</sup> See *Choi (1998)* at 963-5 for analysis.

As noted above, *Gilson & Kraakman (1984)* had argued that the reputational role played by investment bankers significantly reduce the verification costs associated with the dissemination of information under the mandatory disclosure regime - see at 613 - 621. However *Choi (1988)* poses the issue of whether the costs associated with the involvement of an underwriter are justified - particularly in the context of shelf registration as discussed at text accompanying footnotes 66 to 70 of Chapter 6.

<sup>29</sup> See *Folk I (1969)* at 55 and 81; *Note (1977)* at 83; *Note (1983)* at 777.

Having regard to these policy considerations, it has frequently been suggested that underwriters should have the greatest responsibility for the accuracy of a prospectus after the issuer.<sup>30</sup> That conclusion would seem to be a sound basis on which to proceed in the Australian context.<sup>31</sup>

### Corporations Law Reform

While the policy rationale for underwriter liability is well developed in the United States literature, the analysis of the position of underwriters was not given any detailed analysis in developing the *Corporations Law* reforms.

The *SIRC Report* had concluded that a key deficiency in the predecessor statutory provisions was the ambiguity of the position of the underwriter.<sup>32</sup> The *SIRC Report* opted for the imposition of liability on the underwriter because of the advisory role performed by the underwriter.<sup>33</sup> The *SIRC Report* further considered the relative liability position of underwriters and others involved in the process and suggested that the burden of inquiry should not be as great as for directors and that the scope of the inquiry obligations should be spelled out.<sup>34</sup> This view is at odds with the significance of the role of the underwriter in the above analysis.

<sup>30</sup> See *Folk 1 (1969)* at 56. Professor Folk suggests that the burden of investigation imposed on underwriters should be substantially heavier than that imposed on directors. Directors lack the facilities available to underwriters and directors are frequently not specially compensated in order to undertake inquiries in the way underwriters are. As such, it is suggested that there is no sound reason why the due diligence defences should not reflect the strategic position of underwriters in the public distribution of securities.

<sup>31</sup> This conclusion is subject to the debate in relation to underwriter liability for incorporated documents for continuous disclosure prospectuses that is discussed at text accompanying footnotes 66 to 70 of Chapter 6. In the Australian context that debate is less pressing because the underwriter does not face liability for the incorporated documents.

<sup>32</sup> *SIRC Report* at paragraph 2.2.4. It was unclear if an underwriter could be considered to “authorise” or “cause” the issue of a prospectus for purposes of the then liability provisions - for analysis of this point see *Golding (1993)* at 407-8. See also the discussion at Section 2.1 above.

<sup>33</sup> *SIRC Report* at paragraph 6.3.1.

“the underwriter is intimately involved in the structuring and preparation of the issue and ought ... take their share of responsibility.”

<sup>34</sup> *SIRC Report* at paragraph 6.3.2.

“... whilst underwriters and brokers to the issue should accept responsibility for the prospectus, their burden should not be as great. If they are not in fact directors or promoters, then their involvement in the preparation of the prospectus and its issue is a professional function, and should carry an appropriate duty of care.

Accordingly, the Committee proposes two provisions in relation to persons in those capacities who are deemed to have authorised or caused the issue of the prospectus.

The first is a defence of due enquiry, or reasonable steps. That is, if the underwriter or broker establishes that it or its officers took reasonable steps to ensure that the prospectus did not contain false statements or omit material facts, then it will not be liable.

The Committee believes that the legislation should go as far as possible in specifying what an underwriter or broker must do to satisfy its responsibilities. It will not be possible to be absolute about those steps, because it is in the very nature of the responsibility that it calls upon the expertise, qualifications and experience of the underwriter or broker. The duty sought to be imposed is no more or less than a professional duty of care.”

The *SIRC Report* did not separately consider the stockbroking role or the underwriting role of the underwriter. The *SIRC Report* can therefore be criticised as having provided a fairly weak policy basis for regulatory reform. On the other hand, the background materials to the enactment of the *Corporations Law* contained little analysis of the reasons for the imposition of underwriter liability.

The *CLERP Act* contemplates that an underwriter should have potential primary liability, but only to the extent it is performing the “underwriting” role.<sup>35</sup> The *CLERP Fundraising Paper* stated that the underwriter forms part of the core group of people involved in the development of the plan to raise funds. The *CLERP Fundraising Paper* further stated that stockbrokers who are not underwriting the issue “may play a limited role and their responsibility should be the same as for other professional advisers.”<sup>36</sup>

Again, the *CLERP Act* material would seem to have reached conclusions without any rigorous analysis of the various roles performed by the underwriter. To the extent the underwriter is a member of the “core group” as described by the *CLERP Act* materials, the above policy analysis would suggest the underwriter should face liability, whether or not the underwriting role is performed. This is particularly so where the recently developed method of open pricing distribution is adopted.

It would seem that the *CLERP Act* analysis has been confused by the more traditional Australian distribution technique where in a large underwritten offering additional stockbrokers will be engaged by the issuer and lead underwriter to assist in the marketing and distribution of the offering but will not underwrite any shortfall. In these circumstances, the additional stockbrokers will perform a secondary broking role to market the offer (to assist the underwriter in performing its broking role to market the offer), but will not have performed an advisory role or have been engaged in the preparation of the disclosure document.<sup>37</sup>

The *CLERP Act* analysis is defective by virtue of its failure to delineate clearly the circumstances in which underwriter liability should be imposed having regard to the various roles performed by the underwriter.<sup>38</sup> The following analysis will demonstrate that the judicial formulation of the

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<sup>35</sup> *CLERP Fundraising Paper* at 44

<sup>36</sup> *Ibid.*

<sup>37</sup> See analysis in Section 8.5 below.

<sup>38</sup> Further, the *CLERP Act* review involved no attempt to assess how underwriting practices may have been changing during the 1990s as discussed above to determine if policy considerations required a redefinition of the role performed by the underwriter.

duty of care imposed on the underwriter under United States law has been strongly influenced by the legislative history in that jurisdiction.<sup>39</sup> The Australian background materials are much more equivocal as to the standard of care that should be imposed by an Australia court with consequentially greater uncertainty when the issue comes to be determined in Australia.

## 8.2 SUMMARY OF THE REGULATORY PROVISIONS

### Corporations Act

The underwriter does not face potential primary criminal liability under the *Corporations Act* as it is not normally the offeror of the securities under a disclosure document.<sup>40</sup> However, the underwriter may face accessory liability for any criminal contravention.

An “underwriter”, but not a “sub-underwriter”, faces potential primary civil liability under section 729 of the *Corporations Act* for any misstatement in a disclosure document.<sup>41</sup>

The case law suggests that the term “underwriter” is restricted to a person performing the underwriting role as described in Section 8.1 above and that the performance of the stockbroking role or the advisory role will not be adequate for these purposes. In a number of cases the term “underwriting” has been treated as an obligation to subscribe for shares that have not been taken up by the investing public.<sup>42</sup> However, that case law suggests the term should be interpreted having regard to its commercial meaning in the market, rather than by way of any technical legal approach.

In the case of *Aberfoyle Ltd v Western Metals Ltd*<sup>43</sup> the view was expressed that:

“An underwriting must involve some element of risk taking by the underwriter.”<sup>44</sup>

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An additional area that could have been usefully reviewed is the issue of whether technology changes should be a relevant consideration - see the analysis in *Langevoort (1985)* at 770 - 1.

<sup>39</sup> See text accompanying footnote 103 of Chapter 1.

<sup>40</sup> Section 728(1) prohibition and section 728(3) offence. In Australia the issuer or seller of the securities is normally making the offer, not the underwriter, who is acting as an intermediary and purchaser of last resort of the securities.

<sup>41</sup> Section 729(1), Item 4.

<sup>42</sup> See *Re Licensed Victuallers' Mutual Trading Association ex parte Audain* (1889) 42 Ch D 1; *Re London - Paris Financial Mining Corporation Limited* (1897) 13 TLR 569; *Australian Investment Trust Limited v Strand and Pitt Street Properties Limited* (1932) 32 SR (NSW) 534 (on appeal from (1931) 31 SR NSW 266).

This approach is also reflected by ASIC Policy Statement 61 (issued 19 July 1993) and ASIC Policy Statement 145 (issued 1 September 1999).

On this basis Finkelstein J considered that a “best efforts” underwriting would not normally constitute an underwriting.<sup>45</sup>

This result is consistent with the background materials discussed above. That is unfortunate because liability should be imposed on the underwriter who has participated in the planning of the offering, rather than predicating liability on whether the underwriter has assumed risk. A purposive approach might suggest a broader interpretation. However, Chapter 6D itself as well as the background material discussed above seems to suggest a clear distinction was intended between underwriters and stockbrokers as used in the legislation.<sup>46</sup>

The underwriter who faces such potential civil liability will have available to it the due diligence and reasonable reliance defences of Part 6D.3 of the CA.

Even if an underwriter or broker does not face potential primary civil liability under section 729, it may face accessorial liability.<sup>47</sup> Again, such an accessory will have available to it the due diligence and reasonable reliance defences of Part 6D.3 of the CA.

### Comparison with United States

From the outset of the *Securities Act* 1933 there was strong legislative focus on the importance of the role of the underwriter. An underwriter is defined in section 2(11) of the *Securities Act* as a

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<sup>43</sup> *Aberfoyle Ltd v Western Metals Ltd* (1998) 28 ACSR 187 (FCA, Finkelstein J).

<sup>44</sup> *Ibid* at 205.

<sup>45</sup> A best efforts underwriting was described in the case as a commitment to market an offering where the underwriter does not assume any risk if the issue is undersubscribed nor does the underwriter give a firm commitment to subscribe for any securities. In other words, the underwriter is performing the stockbroking role described above.

Finkelstein J assumed, without deciding, that a “firm commitment” underwriting (being a commitment to subscribe for securities irrespective of the number of securities subscribed for by other investors - as such this underwriting is a direct subscription for a specified number of shares) would be encompassed within the term.

<sup>46</sup> For the purposes of section 710 the persons who have relevant knowledge for determining the required disclosure in a prospectus include a person named as a stockbroker in relation to the issue or sale if they participate in any way in the preparation of the prospectus (section 710(3)(e)). This anomaly is highlighted by the fact such a stockbroker does not have a supplementary disclosure obligation under section 730.

It would have been more consistent with the policy of the CA to provide for potential civil liability for a stockbroker as referred to in section 710(3)(e) instead of an underwriter (but not a sub-underwriter) in that it is a stockbroker of that description (whether or not performing the underwriting role) who should fact potential liability for the reasons outlined in section 6.1.

In relation to this analysis it should be noted that a relatively recent Australian practice in open pricing offerings is for the broker to agree in the broking agreement it has with the issuer or seller that it will underwrite the obligation of institutional investors in the bookbuild to settle their obligation to subscribe for the securities offered in the institutional offering. The effect of such an agreement is to elevate the potential liability of the broker to an underwriter for purposes of section 729 because the underwriter will then be assuming risk as contemplated by the underwriter cases referred to above.

<sup>47</sup> Section 729(1), Item 6. This consequence arises, consistent with the above analysis, if the underwriter or stockbroker has not performed the underwriting role as described in section 6.1

person who has purchased from the issuer or offers or sells for the issuer securities in connection with their distribution. As such, the term extends both to underwriters who have performed an underwriting role as well as stockbroking role.<sup>48</sup>

In the United States an underwriter does not face potential primary criminal liability for a prospectus misstatement in the absence of knowledge of the misstatement.<sup>49</sup>

The underwriter faces potential primary civil liability for a prospectus misstatement under section 11 of the *Securities Act*, subject to the due diligence defence of section 11.<sup>50</sup> Since an underwriter resells securities to investors under United States practice, as described in Section 8.1, the underwriter also faces potential primary civil liability under section 12(2) of the *Securities Act*, subject to the reasonable care defence of section 12(2).<sup>51</sup>

One important distinction between the liability of an underwriter under the *Securities Act* and under the *Corporations Act* is the cap on underwriter liability contained in section 11 of the *Securities Act*. Section 11(e) of the *Securities Act* provides that an underwriter's liability for a prospectus misstatement is limited to the amount actually underwritten by that underwriter.<sup>52</sup>

This provision was added to section 11 with the 1934 amendments to the *Securities Act* as a consequence of lobbying conducted by the investment banking community. There would appear to be no good reason in policy for such a cap, in that having regard to the strong policy

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<sup>48</sup> See *Dooley (1972)* at 793 - 4.

<sup>49</sup> See Section 2.2.

<sup>50</sup> Section 11 (a)(5) of the *Securities Act*.

<sup>51</sup> In the United States context where underwriters and brokers underwrite securities issues by acquiring the securities from the issuer and then redistributing through dealing networks, a direct contractual relationship is established between the underwriter and investors acquiring the securities pursuant to the prospectus.

Clearly, such an arrangement constitutes a sale in the traditional sense.

In the 1988 Supreme Court decision of *Pinter v Dahl* 486 US 622 (1988), the court made the following observations on the position:

“the applicability of ss12 liability to brokers and others who solicit securities purchases has been recognised frequently since the passage of the *Securities Act*...an interpretation of statutory seller that includes brokers and others who solicit offers to purchase securities furthers the purposes of the *Securities Act* - to promote full and fair disclosure of information to the public in the sale of securities. In order to effectuate congress' intent that ss12(2) civil liability be in terrorem...the risk of its invocation should be felt by solicitors of purchasers. The solicitation of a buyer is perhaps the most critical stage of the selling transaction”. (at 651)

<sup>52</sup> Section 11(e) provides:

“In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorised under subsection (a) for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public.”

In Australia, the *Corporations and Securities Industry Bill 1974* had proposed a similar limitation (section 171(6)). However since that time no review of the Australian legislative provisions has identified this as an issue for consideration.

justification for underwriter liability as outlined above it is appropriate that the underwriter is placed in the same position as other participants in the capital raising process with primary liability. As such, this provision of section 11 should not be seen as having much application to the debate in Australia.

### Other Jurisdictions

The position with regard to underwriters is more complicated in England than in other jurisdictions because of the continuing failure of the legislation to specifically identify the position of the underwriter as a person facing potential primary liability.<sup>53</sup> It is not clear whether or not an underwriter will face potential primary civil liability.<sup>54</sup> The English regime is therefore a poor model in this area.

By way of contrast, Canada generally adopts the same approach as the United States, imposing underwriter liability for prospectus misstatements.<sup>55</sup> The reasons for the imposition of underwriter liability in Canada were said to be the same as for the United States.

### 8.3 CASE LAW PRECEDENT ON UNDERWRITERS

In assessing the position of the underwriter under the *Corporations Act* it is useful to survey the case law precedent that exists.

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<sup>53</sup> For criticism of the UK regime failure to deal specifically with underwriters see *Turner (1989)* at 107.

<sup>54</sup> Under the *Financial Services and Markets Act 2000* and *The Public Offer of Securities Regulations 1995*, liability exists for the following persons:

- each person who accepts responsibility for the relevant disclosure statement; and
- each person not falling within any of the above who has authorised the contents of any part of the document.

See paragraph 6(1)(d) and (e) of the *Financial Services and Markets Act 2000 (Official Listing of Securities) Regulations 2001* and Section 13(d) and (g) of *The Public Offers of Securities Regulations 1995*.

Under the legislation a person is considered to offer securities if as principal he makes an offer that, on acceptance, would give rise to a contract of sale or invites such as offer - section 5 of *The Public Offers of Securities Regulations 1995*. Depending on the structure of the offering this may result in the underwriter being treated as an offeror of securities. See *Gleeson & Bloomenthal (1999)* at 439 - 440.

Further, the UK Listing Authority requires a listing to be "sponsored" by an approved entity. The underwriter is typically the sponsor. The sponsor must ensure that the issuer is properly guided and confirm to the UK Listing Authority that the issuer is an appropriate entity to be listed. In addition, if a forecast is included in the prospectus (not typically the case) the sponsor must confirm to the UK Listing Authority that the forecast has been made after due and careful inquiry by the directors of the issuer. While this responsibility is expressed to be owed solely to the UK Listing Authority, the potential impact in terms of the liability provisions set out above is unclear. See *Gleeson & Bloomenthal (1999)* at 440 - 1.

For advocacy of a broader view that the underwriter will accept responsibility so as to trigger general liability see "*Gore - Browne on Companies*" (looseleaf) at paragraph 11.4.

<sup>55</sup> See for example section 103(1)(b) of the *Ontario Securities Act*.

### Australian/Commonwealth Material

There is no Australian or Commonwealth case law in relation to the position of the underwriter where a misstatement exists in a disclosure document that the underwriter has been involved in preparing.

In view of the pivotal role played by the underwriter in the prospectus preparation process and in the selling of securities pursuant to the prospectus, this is clearly an odd result. As such, the absence of judicial consideration of the position of the underwriter under the pre-existing securities laws of Australia and under the common law suggests that there was a compelling need for reform in relation to the underwriter.

The absence of judicial consideration of the underwriter initially resulted in a considerable degree of nervousness on the part of underwriters in Australia in determining the appropriate role that they should perform in prospectus preparation under the new *Corporations Law*.<sup>56</sup>

### United States Material

It is in the United States that the most useful precedent exists as to underwriter liability and the standard of conduct required to establish the due diligence defence.

The earliest judicial material of relevance to the underwriter is *In the Matter of the Richmond Corp*,<sup>57</sup> a 1963 decision involving a stop order issued by the SEC. The SEC held a prospectus to be false and misleading, among other reasons, because the inexperience of the underwriter was not disclosed.<sup>58</sup> In addition the SEC considered that the underwriter was deficient in its performance of investigatory duties because, other than visiting the issuers' properties, examining stock lists and obtaining a credit report, the underwriter had relied entirely on management for the accuracy of the prospectus. The SEC considered that such a limited investigation did not meet the degree of reasonable inquiry necessary to satisfy the underwriter's obligation to verify the accuracy of the prospectus.

As in Australia, section 11 and section 12(2) of the *Securities Act* does not affirmatively require due diligence to be conducted - the only consequence is that if there is a misstatement no defence

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<sup>56</sup> As evidence of this mood of concern see S. Walker "Underwriter's Liability: Upping the Ante in the 1990's" (1989) 11 Legal Issues 10; M. McGrath "Underwriters Can't be Overcareful" (1992) JASSA Volume 4, page 7.

<sup>57</sup> *In the Matter of the Richmond Corp* 41 SEC 398 (1963).

<sup>58</sup> *Ibid* at 403. The underwriting was on a best efforts basis (ie the underwriter did not assume any underwriting risk).

is available to potential liability. However, the SEC considered that by being named in the prospectus the underwriter impliedly represents it has investigated the issuer.<sup>59</sup> As such, *In the Matter of the Richmond Corp* is authority for the proposition that a duty of independent inquiry is imposed on underwriters by section 11.<sup>60</sup> This approach is clearly consistent with the policy reasons advanced above for underwriter liability.

The position of the underwriter was extensively canvassed by a court for the first time in 1968 in the *BarChris Case*. Drexel & Co, as managing underwriter, and a syndicate of underwriters were all held liable under section 11 of the *Securities Act* in the *BarChris Case*. The facts of the *BarChris Case* were described in Chapter 7.

In the *BarChris Case* the lead underwriter had conducted due diligence inquiries. In addition, the underwriting syndicate had retained its own legal adviser to assist it. It is also relevant to note that a partner of Drexel became a director of the issuer a month before the prospectus was issued.<sup>61</sup>

Prior to agreeing to become underwriter, the underwriter and the director appointed by it had conducted general inquiries to determine if Drexel should take on the underwriting assignment.<sup>62</sup> Representatives of Drexel and Drexel's lawyers met three times with management of the issuer to discuss the offering and the drafts of the prospectus prepared by the issuer and a number of issues were raised by Drexel with the issuer concerning financial matters. At those meetings questions were raised in relation to matters that ultimately were determined to constitute misstatements in the prospectus. Drexel and its advisers received assurances that the prospectus was accurate on these matters.<sup>63</sup>

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<sup>59</sup> Ibid at 406. This might be a tenuous argument for ASIC to mount under the *Corporations Act* stop order provisions. The premise of the exercise of those rights is a ground of belief that the prospectus contains a misstatement. Insufficient verification or due diligence does not immediately equate to a grounds for exercise of the power unless a misstatement exists.

Under the *Corporations Act* the stop order power requires ASIC to be satisfied that the offer of securities would contravene the misstatement standard set out in section 728 (section 739(1)). This is the same statutory basis for the exercise of the United States power (see section 8(d) of the *Securities Act* 1933). See Section 5.2

<sup>60</sup> To similar effect see the earlier SEC decision of *Charles E Bailey & Company* 35 SEC 33 (1953). Also see the background materials referred to in *Greene (1981)* at 772.

<sup>61</sup> *BarChris Case* at 693. For discussion as to his position see Section 7.2.

<sup>62</sup> Involving reading prior prospectuses and annual reports, reading industry materials and confirming the issuer's standing with banks and credit factors - *BarChris Case* at 693.

<sup>63</sup> *BarChris Case* at 694.

In addition, Drexel's lawyers had reviewed the issuers' minute books for the last five years and its major contracts. However, when Drexel's lawyers were advised that some minutes were not written up they did not pursue the matter. In addition, the review of major contracts was cursory and did not include a review of contracts that would have disclosed serious issues.

While Judge McLean considered that the underwriter believed the statements in the prospectus to be true he decided that the due diligence defence had not been established because of inappropriate reliance by the underwriter on management representations. Judge McLean considered the role of the underwriter to be adversarial in nature and required independent verification by it of information provided by the issuer:

*“In a sense the position of the underwriter and the company's officers are adverse. It is not unlikely that statements made by company officers to an underwriter to induce him to underwrite may be self-serving. They may be unduly enthusiastic. As in this case, they may, on occasion, be deliberately false.*

The purpose of section 11 is to protect investors. To that end the underwriters are made responsible for the truth of the prospectus. If they may escape that responsibility by taking at face value representations made to them by the company's management, then the inclusion of underwriters among those liable under section 11 affords the investors no additional protection. To effectuate the statute's purpose, the phrase “reasonable investigation” must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of “data presented” to them by the company. It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the company's officers are truthful and reliable. *In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them.”*<sup>64</sup> [emphasis added]

As noted above the only detailed verification of statements made by management was undertaken by the underwriters' legal advisers. The lawyers had delivered to the underwriters a legal opinion confirming that the lawyers did not consider the registration statement contained any misstatement.<sup>65</sup>

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<sup>64</sup> *BarChris Case* at 697. The principles of underwriter inquiry reflected in this quote will generally be referred to as the “verification/adversary role” of the underwriter.

<sup>65</sup> The legal opinion provided that:

“We are of the opinion that the data presented to us are accurately reflected in the registration statement and prospectus and that there has been omitted from the registration statement no material facts included in such data. Although we have not otherwise verified the completeness or accuracy of the information furnished to us ... we have no reason to believe that the registration or prospectus contains any untrue statement of any material fact or omits to state a material fact”  
(*BarChris Case* at 695-6).

In other words, the legal opinion contained the negative assurances opinion on disclosure that has become commonplace in Australia.

Judge McLean considered that the inquiries undertaken by the lawyers to be inadequate. Reliance on the lawyers and their legal opinion in the circumstances of the case would therefore not constitute reasonable investigation by the underwriters:

“It is not a matter of relying upon counsel for legal advice. ... we are dealing with matters of fact. Drexel delegated to them, as its agent, the business of examining the corporate minutes and contracts. It must bear the consequences of their failure to make an adequate examination.”<sup>66</sup>

On the other hand Drexel and the other underwriters were not held liable for the misstatements in the expertised portions of the prospectus prepared by the issuer’s auditors. The underwriters were not considered to have reasonable grounds to suspect a misstatement in those portions of the prospectus.<sup>67</sup> The analysis in the *BarChris Case* of the expertisation defence in section 11 as it applies to an underwriter is quite cursory.<sup>68</sup>

The *BarChris Case* gave rise to a torrent of comment in relation to the underwriter’s position.<sup>69</sup> It was clear that the underwriter was considered to have a pivotal role in the offering process giving rise to obligations of independence and verification of information presented.<sup>70</sup>

What is again striking about the *BarChris Case* is that while each participant in the prospectus preparation process had the same reasonable investigation defence, the court imposed very different obligations of inquiry and verification on the underwriter as contrasted with others.<sup>71</sup>

The role of the underwriter was the subject of further analysis in the *Feit Case*. While the case involved a scrip takeover offer, the dealer-managers involved in the takeover were treated as underwriters for the purposes of section 11 of the *Securities Act*.<sup>72</sup>

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<sup>66</sup> *BarChris Case* at 697.

<sup>67</sup> *BarChris Case* at 697. This position can be contrasted with the position of the inside directors who were held liable in relation to the misstatements in the expert report.

<sup>68</sup> The reasonableness of the right for underwriters to rely on the work product of accountants has been supported by subsequent case law. For example in the long running *John Nuveen & Co* case law the dissenting opinion of the Supreme Court (in denying certiorari) stated (Justice Powell) that “almost by definition, it is reasonable to rely on financial statements prepared by public accountants” - *John Nuveen & Co v Sanders* 49 USLW 3706 (1981) at 3707.

<sup>69</sup> In addition to *Folk 1 (1969)* and *Folk 2 (1969)*, see for example Comment “*BarChris: Due Diligence Refined*” (1968) Columbia L Rev 1411; Whitney “*Underwriter Counsel - Advice to my Clients: “That Which is Impossible Must Go Away!”*” (1969) 24 Bus Law 585; Note “*The Expanding Liability of Securities Underwriters: From BarChris to Globus*” (1969) Duke LJ 1191.

<sup>70</sup> See *Folk 1 (1969)* at 56 and 72; Comment “*BarChris: Due Diligence Refined*” (1968) Colum L Rev 1411 at 1421.

<sup>71</sup> Compare to the analysis of the director in Chapter 7. See also for example *Folk 1 (1969)* at 20 - 42, 68 - 71.

<sup>72</sup> A “dealer-manager” in the United States is the offeror’s investment bank responsible for seeking acceptances for the scrip takeover.

The dealer-managers had conducted detailed due diligence inquiries in relation to the offeror's takeover documentation. The dealer-manager was familiar with the key issue surrounding the calculation of surplus<sup>73</sup> but had been advised that the target would not assist the offeror. At all times the dealer-manager was advised by the issuer that the target would not disclose any of the necessary financial information to it that would allow a calculation of surplus to be included in the offer documents. After being appraised of all relevant facts the legal adviser to the dealer-manager rendered a legal opinion that an estimate of surplus could not properly be included in the document.<sup>74</sup>

Judge Weinstein concluded that the dealer-managers had "just barely" established their section 11 due diligence defence on the basis of the inquiries that had been conducted.<sup>75</sup> It would seem critical to the conclusion reached by the judge that detailed enquiries had been conducted but at all times the dealer-managers were unaware that target might assist the issuer in estimating the amount of surplus.<sup>76</sup>

In reaching that decision Judge Weinstein endorsed the analysis of Judge McLean in the *BarChris Case*. He concluded:

"An underwriter cannot, of course, be expected to possess the intimate knowledge of corporate affairs of inside directors, and their duty to investigate should be considered in light of their more limited access. Nevertheless they are expected to exercise a high degree of care and investigation and independent verification of the company's representations. Tacit reliance on management assertion is unacceptable; the underwriters must play devil's advocate."<sup>77</sup>

Clearly it was the inability of the underwriter to access relevant information that was determinative in this case in favour of the underwriter.

The principles of the *BarChris Case* and the *Feit Case* as they apply to the underwriter under section 11 have been endorsed in a number of subsequent United States decisions.<sup>78</sup> For

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<sup>73</sup> Dealer-manager representatives were familiar with the insurance industry and were aware of the two estimates of surplus surplus available to the offeror. *Feit Case* at 561. A series of due diligence meetings had been held with the offeror. For details of the surplus surplus issue see Chapter 7.

<sup>74</sup> *Feit Case* at 562.

<sup>75</sup> *Feit Case* at 582.

<sup>76</sup> See Chapter 7. *Feit Case* at 582-3.

<sup>77</sup> *Feit Case* at 582.

<sup>78</sup> See for example *Competitive Associates, Inc v International Health Sciences, Inc* [1975] Sec Reg L R (CCH) 94,966; *In Re the Gap Stores Securities Litigation* 79 FRD 283 (ND Cal 1978); *Sanders v John Nuveen & Co* 49 U.S.L.W. 3706 (1981) at 3707; *Ahearn v*

example, in *Basic Inc v Levinson*,<sup>79</sup> the United States Supreme Court endorsed the approach adopted in the *BarChris Case* in assessing the position of the underwriter.

Since the *BarChris Case* and the *Feit Case*, underwriters have become customary defendants in most United States securities laws cases. The case law on underwriter liability has had the result that underwriters find themselves in the inner group of defendants with the issuer and directors in facing that potential liability.

In the United States the imposition of liability on underwriters for shelf registration prospectuses has been a contentious issue having regard to the speed at which those offerings take place.<sup>80</sup> As has been discussed, a number of commentators have suggested that underwriter liability is inappropriate for periodic disclosure documents incorporated into a shelf registration prospectus. However there has been no regulatory move to assist the underwriter in those offerings.

### Canadian Material

There is a small body of Canadian material that is also of assistance in assessing the position of the underwriter.

In the 1972 Ontario Securities Commission decision of *A.E. Ames & Co Ltd*<sup>81</sup>, the commission ruled that an underwriter must conduct an independent investigation of the issuer and cannot simply rely on the issuer for information disclosed in a prospectus. The relevant Ontario legislation<sup>82</sup> required the underwriter to swear a certificate that to the best of its knowledge and belief the prospectus constituted full, true and plain disclosure of all material facts. The underwriter had consulted with the issuer's lawyers and requested responses to certain questions, but had signed the certificate before receiving those responses. The Commission found that the

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*Gaussoin* [1985-6] Sec Reg L R (CCH) 92,332 (D Or.); *In Re Victor Technologies Securities Litigation* [1987] Sec Reg L R (CCH) 93,158 (ND Cal); *In Re Software Toolworks, Inc Securities Litigation* 789 F Supp 1489 (ND Cal, 1992).

It can be argued that many of these later cases illustrate a more lenient approach than reflected in the *BarChris Case*, at least in the results of the cases.

<sup>79</sup> *Basic Inc v Levinson* 485 US 224 (1988).

<sup>80</sup> See the discussion in Section 6.2.

<sup>81</sup> *A E Ames & Co Ltd* (1972) OSCB 98.

<sup>82</sup> The predecessor legislation to the *Securities Act* 1980 (Ontario).

underwriter must seek out and question all relevant and material facts and cannot simply rely on the statements and opinions of the issuer, its directors, officers and counsel.<sup>83</sup>

The views of the Commission on this point are clearly consistent with the earlier United States precedent of *In the Matter of the Richmond Corp* and the *BarChris Case*.<sup>84</sup>

## 8.4 ASSESSMENT OF POSITION OF UNDERWRITERS

### Standard of Conduct Required

Prior to the enactment of the *CLERP Act*, the likely application of the due diligence defence to the underwriter was confused because of the terms of the particular due diligence defence available to the underwriter.<sup>85</sup>

However, with the enactment of the *CLERP Act* the terms of the due diligence defences available to the underwriter brings the terminology of the Australian statutory position broadly into alignment with the United States statutory provisions. The terms of the underwriter defence are linguistically identical to the standard of conduct required of a director and extend to the entire prospectus.<sup>86</sup> Having regard to the similarity of the statutory provisions, the United States material should be strongly influential in the Australian context.

What differs between the United States provisions and the Australian provisions is the different legislative history that led to the adoption of the two regimes. The case law outlined above suggests that the United States courts have been strongly influenced by this legislative history in developing the adversarial or devil's advocate requirements imposed by the *BarChris Case* and the *Feit Case*.

The Australian regime has developed with much less debate in the legislative history as to the role played by the underwriter. As discussed in Section 8.1, the reform process can be criticised for its failure to enunciate clearly the reasons for imposition of underwriters liability and relevant policy considerations that should bear upon that imposition of liability. Indeed, the

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<sup>83</sup> Ibid at 112-3.

<sup>84</sup> The Canadian journal material proceeds on the basis that as a general matter Canadian courts will treat the position of the underwriter in a similar manner to that of United States courts. See analysis in *Pacific Coast Coin Exchange of Canada Ltd v Ontario Securities Commission* 80 DLR (2d) 529 (1977) discussed in *Simmonds* (1979). See also the analytical approach reflected in *Albioni* (1982); *Rodier* (1985); *Thompson* (1988).

<sup>85</sup> Pre-*CLERP CL* section 1011. For analysis of the position see *Golding* (1993) at 410-412 and 416-420. See also the criticisms of CL Section 1011 described in Section 4.1.

<sup>86</sup> Compare the analysis to this effect in *Feit I* (1969) at 52.

recommendations of the *SIRC Committee* had suggested an expressed lower standard of liability than for the issuer and its directors.

For these reasons, it may be that an Australian court adopts a more lenient attitude to underwriters inquiries in establishing the due diligence defence than has been the case in the United States.

However, it is submitted that would be a mistake. As outlined above, the policy reasons for imposition of underwriter liability should be considered to be the same in Australia as in the United States. In terms of market efficiency considerations, the imposition of a verification role on the underwriter assists in reducing the costs to the market of verification and drives market efficiency. As such, it would be appropriate from the policy perspective to apply the United States jurisprudence to Australia and any difference in legislative history should be disregarded.

### **The General Approach of Underwriter to Inquiries**

To meet the standard of conduct expected of the underwriter, regard should be had to the following considerations in participating in the Australian due diligence process as described in Section 4.4:

- The underwriter should tailor its inquiries conducted through the due diligence committee to bolster arguments that it has performed a verification/adversary role.<sup>87</sup>
- The underwriter should ensure that it has had access to management to test personally management assertions concerning the position of the issuer, whether that occurs through the due diligence committee or independently of it.
- The underwriter should take particular care to ensure that verification of the prospectus has been properly performed, as verification is fundamental to the underwriter's position.

If the above analysis is accepted, certain aspects of the Australian approach to due diligence on which underwriters may have placed significant reliance, are of limited usefulness. For example, the management certificates described in Section 4.4 will not provide any meaningful protection to the underwriter.

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<sup>87</sup> See *Folk I* (1969) at 79-82.

### Delegation of Inquiries and Reliance

Implicit in the Australian approach to due diligence is the concept of delegation of inquiry by each member of the due diligence committee, including the underwriter.

The position of directors and underwriters in terms of reasonableness of reliance on management may vary quite markedly because of the verification/adversary role. Director reliance on delegated inquiries has been discussed in Chapter 7. However even with the difference in the position of directors and underwriters, there is nothing to suggest that recognition of the general ability to delegate inquiries that flows from the director cases may not apply with equal force to the position of the underwriter. Indeed, in the *BarChris Case* the ability of the underwriter's lawyer to perform fact finding functions was not criticised by the court.<sup>88</sup>

It can therefore be concluded that there is nothing to prevent delegation of inquiries by the underwriter in the manner contemplated by the Australian approach to due diligence.

### 8.5 UNDERWRITING SYNDICATES

Difficult issues arise in relation to the due diligence defences in circumstances where a group of underwriters agree to underwrite an issue of shares. In addition, for large public issues, a network of sponsoring brokers may need to be arranged to organise the distribution of the securities offered. Each member of a syndicate of underwriters will have deemed liability under the *Corporations Act* in the same way as a sole underwriter.<sup>89</sup> In each of these cases it may prove to be too unwieldy for each underwriter to conduct due diligence investigations. As such, it is normally the case that a lead underwriter or a small group of lead underwriters will conduct inquiries on behalf of the syndicate.

In the *BarChris Case* both the lead underwriter and each participating underwriter failed to establish the due diligence defence. For the reasons outlined in Section 8.1, underwriting syndicates have been a traditional feature of United States securities distribution techniques for many years. However, the court did not consider the issue of whether participating underwriters who rely on a lead underwriter will be protected if the lead underwriter has established its due

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<sup>88</sup> See *BarChris Case* at 697.

<sup>89</sup> Note however that sub-underwriters and stockbrokers are not expressed to have primary civil liability - see the discussion in Section 6.2 above.

diligence defence.<sup>90</sup> This has given rise to a continuing debate in the United States as to the criteria that will need to be established for a participating underwriter to establish its due diligence defence.<sup>91</sup>

Professor Folk has argued that the legislative objective of imposing liability on underwriters is satisfied through the lead underwriter undertaking investigations. Folk suggests that:

“The congressional purpose of protecting investors is largely accomplished if the lead underwriter makes a satisfactory investigation. Although supplementary, independent inquiries by the participating underwriters might occasionally dredge up an additional misstatement, the margin of improvement probably would not warrant the expense and confusion of proliferating inquiries. Such a quest for the perfect prospectus would not be worth the effort.”<sup>92</sup>

Folk therefore argues that this policy analysis supports the conclusion that a participating underwriter should be entitled to delegate inquiry functions to the lead underwriter and rely completely on the lead underwriter for its defence.<sup>93</sup> As a consequence, a participating underwriter will only be liable if the lead underwriter has not exercised due diligence. This view of course poses risks to participating underwriters if the lead underwriter does not conduct a proper inquiry.<sup>94</sup>

On the other hand, the United States Securities Exchange Commission has indicated that it expects a participating underwriter to undertake a limited “double checking” review of the lead underwriter’s work so that the participating underwriter can satisfy itself that it is reasonable to rely on the lead underwriter’s investigation before its defence can be established.<sup>95</sup> The

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<sup>90</sup> Footnote 26 to *BarChris Case* (at 697) notes that as Drexel did not establish the due diligence defence and the other underwriters relied solely on Drexel “it becomes unnecessary to decide whether the underwriters other than Drexel would have been protected if Drexel had established that as lead underwriter, it made a reasonable investigation”. This also reflects the United States practice where the manager of the offering will formally be delegated the task of conducting inquiries on behalf of the underwriting syndicate - see *Freund & Hacker* (1974) at 465 and 470.

<sup>91</sup> See for general discussion of the issues *Folk I* (1969) at 56-8; *Freund & Hacker* (1974) at 470-1; *Thompson* (1988) at 303-4. For case law support that if the manager establishes its defence all members of the syndicate will do, so see *Competitive Associates, Inc v International Health Sciences, Inc* [1974-5 Transfer Binder] Fed Sec L Rep 94, 966 (SDNY 1975). The difficulties in imposing the same standard of culpability on all underwriters in an underwriting syndicate had been identified at the time of adoption of the *Securities Act* 1933 where it was suggested the imposition of liability in these circumstances might damage the efficiency of the underwriting process - see *Douglas & Bates* (1933) at 199-203.

<sup>92</sup> *Folk I* (1969) at 57.

<sup>93</sup> See *Folk I* (1969) at 56-8. For other advocates see *Note* (1977) at 85 arguing that syndicate members will be encouraged to only join syndicates where they trust the manager and the manager will thereby be encouraged to take care.

<sup>94</sup> From the participating underwriter’s perspective that risk may be ameliorated to some extent through contractual arrangements in the underwriting agreements or through the tort of negligence - it would seem the relationship between the lead underwriter and participating underwriter or brokers may give rise to a duty of care.

<sup>95</sup> Securities Exchange Commission Release No. 5275 (1972). See also *Freund & Hacker* (1974) at 479-80 describing 1973 proposals of the National Association of Securities Dealers to require managing underwriters to certify to participating underwriters that adequate

theoretical difficulty with that approach is that it may lead to the somewhat illogical situation where the lead underwriter has established its defence but the participating underwriters do not.<sup>96</sup>

Most authority that exists in the United States favours the Folk view. For example *In Re Gap Stores Securities Litigation*<sup>97</sup> both the Folk formulation and the alternative SEC formulation were canvassed. The Folk formulation was preferred by that court.<sup>98</sup>

In Australia it would seem that the section 733 reasonable reliance defence allows scope for a participating underwriter to argue that it is reasonable for it to rely on a lead underwriter in circumstances where the lead underwriter has expertise in its involvement in due diligence procedures and the participating underwriter is aware that detailed due diligence inquiries have been conducted.<sup>99</sup>

That approach is of course consistent with the Folk view. Such an approach should be preferred in Australia over the alternative views for the reasons outlined above.

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due diligence procedures have been prescribed and those procedures have been followed. Following industry protest the proposals were dropped.

<sup>96</sup> Having regard to the pivotal position of the lead underwriter it has been argued that the cap on liability equal to the amount underwritten should be removed in the case of the lead underwriter - see *Klinges (1985)* at 1064 (the thesis of that article is that uncapped liability may be accessed through a section 12(2) claim - see at 1072-1082).

<sup>97</sup> *In Re Gap Stores Securities Litigation* 79 FRD 283 (ND Cal 1978).

<sup>98</sup> *Ibid* at 300-1.

See also *Note (1977)* at 84-86. It is argued that the SEC approach has the advantage that a double check may result in early detection of lead manager negligence. On the other hand, the *BarChris Case* approach of tying liability to the conduct of the manager may result in greater care by lead managers because, if there is a reputation for lax standards, that would negatively impact on the ability of the lead manager to form syndicates.

<sup>99</sup> That approach would require the participating underwriter to establish that the lead underwriter is not an agent of the participating underwriter for these purposes - see the analysis in Section 4.1.

## CHAPTER 9

### ADVISOR LIABILITY

The *Corporations Act* imposition of potential primary civil liability for prospectus misstatement to all professional advisors, experts and other external parties assisting in the prospectus preparation process (referred to for convenience in this chapter as “advisors”) was a dramatic expansion of the potential scope of liability from that existing prior to the 1990s. In addition, the Australian regime in the initial *Corporations Law* was unique in imposing potential direct liability on these persons, rather than linking liability to the preparation of any expert report.

This chapter considers the potential scope of the Australian regime and the desirability of imposing direct liability on advisors from the policy perspective.

#### 9.1 ADVISORS AS GATEKEEPERS

The imposition of potential primary liability on advisors finds its policy support in theories of gatekeeper liability.<sup>1</sup> That proposition follows both from the involvement of the advisor as a participant in the capital raising process and also the role of the advisor as reputational intermediary in giving a representation of quality to the offering.<sup>2</sup> However, the strength of that proposition is much weaker than the policy underpinnings for the other participants involved in the capital raising process discussed in prior chapters (the issuer, insiders and underwriters).

These reasons were also given as justifications for imposing potential liability on underwriters (see Chapter 8). However, the underwriter is directly involved in the marketing of the offer to potential investors and will have a broader involvement in the overall preparation of the disclosure document, unlike the advisors who will be largely unknown to retail investors and will apply discrete professional skills to the prospectus preparation process.

The likelihood of investor reliance on the reputation of advisors as a representation of quality is likely to be less in the case of advisors than an underwriter because the advisor has no direct association with potential investors and no representation is typically made as to the verification functions performed by a particular advisor.<sup>3</sup> On the other hand, it can be argued, based on

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<sup>1</sup> See text accompanying footnotes 18 to 27 of Chapter 3.

<sup>2</sup> Advisors have been described as “incorruptible outsiders ..... [employed] to gain legitimacy or expertise or to meet a legal requirement” in describing their gatekeeper status. See *Kraakman (1984)* at 891.

<sup>3</sup> *Donohue (1990)* at 126.

economic efficiency grounds, that verification function obligations should be imposed on advisors, as advisors are better equipped to perform verification functions more cost effectively than third party investors.<sup>4</sup> Nevertheless, those verification functions will be performed by advisors because the issuer, directors and underwriters will need to use the skills of the advisors to place themselves in a position to establish their own due diligence defences.

As a consequence, it can be argued that policy arguments based on gatekeeper theories do not suggest a particularly strong basis for imposing primary liability on all advisors involved in the capital raising process.

It can be argued that there is a degree of self interest<sup>5</sup> in the above policy analysis. Indeed, as noted in Section 1.3 above, some commentators had suggested that a particular problem with the securities laws in Australia in the 1980s was the laxity of the professions, primarily lawyers and accountants, and a culture among the professions of facilitating loopholing.<sup>6</sup> The failed criminal prosecutions against advisors in the early 1990s might add further support to that view.<sup>7</sup> If that view was correct the imposition of gatekeeper liability might be argued to perform a needed deterrence function in improving professional standards in Australia.

However, that view is anecdotal in its nature and there is little to suggest that Australian advisors are less professional than their counterparts elsewhere. In addition, this criticism is a comment on the securities laws generally rather than prospectus liability specifically. Gatekeeper liability for advisors is not a feature of any other provision of the Australian securities laws (beyond the extent to which the advisor has liability as an accessory).

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<sup>4</sup> See the debate described in Section 1.6.

<sup>5</sup> Have regard to the fact that the author is a lawyer practising in this area.

For criticism of the relaxation of the *CLERP Act* see *Whincop (1999)* at 26, arguing that the change smacks of special interest politics. Whincop argued instead for a power for ASIC to grant relief to advisors for liability based on disclosure of the actual involvement of the advisor in the prospectus preparation process.

<sup>6</sup> At text accompanying footnote 28 (citing *Tomasic (1990)*).

For a similar sentiment in the United States context see H.E. Jackson “*Reflections on Kaye, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions*” (1993) 66 S Cal L Rev 1019 (in the context of the savings and loan scandal of the early 1990s in the United States).

In connection with the same events Sporkin J said in *Lincoln Savings & Loan Association v Wall* 743 F Supp 901 (DDC 1990):

“Where were these professionals when these clearly improper actions were being consummated? Why didn’t any of them speak up or disassociate themselves from the transaction? Where also were the outside accountants and attorneys when these transactions were effectuated. What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in the case” (at 920).

<sup>7</sup> See text accompanying footnotes 33 to 36 of Chapter 1.

Ultimately the concern of advisors will be that they may be targeted in the civil liability context because they have deep pockets through their professional indemnity insurance arrangements. It is important that an appropriate balance be struck between the potential liability of the advisor and their actual position in the prospectus preparation process.

From the policy perspective, the importance of this proposition is illustrated by comments made by the majority in the US Supreme Court decision of *Central Bank of Denver NA v First Interstate Bank of Denver NA*.<sup>8</sup> There, in concluding that private civil liability does not extend to a person that may aid and abet a violation of Section 10(b) and Rule 10b-5 under the *Securities Exchange Act 1934*, the Supreme Court noted that expanding liability to those involved in securities violations may impose “costs that disserve the goals of fair dealing and efficiency in the securities markets”.<sup>9</sup> The costs of securities litigation and the risk of increasing the costs charged to business through professional fees were particularly noted. This reflects a recent concern of the Supreme Court that the Rule 10b-5 remedy not be too broadly stated.<sup>10</sup> In the Australian context, clearly the cost of capital raising would be raised if all advisors or professionals named in an offering document were required to undertake due diligence of all disclosures in the disclosure document to safeguard their position.

Ultimately, the policy issue is one of balancing competing interests. It is clear that advisors do perform a level of gatekeeping function and the argument can be made that some potential primary liability is appropriate. However, imposition of liability on the advisor in question clearly should be restricted to an advisor that is performing a gatekeeper role in relation to the prospectus preparation process. Second, it must be seriously questioned whether is appropriate to impose liability on such a gatekeeper where the advisor has not been involved in the violation of law in question.<sup>11</sup>

Irrespective of the outcome of that debate, the advisor will also face potential secondary liability as an accessory through their participation in the prospectus preparation process.

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<sup>8</sup> *Central Bank of Denver NA v First Interstate Bank of Denver NA* 114 SC 1439 (1994)

<sup>9</sup> Ibid at 1494.

<sup>10</sup> See also *Blue Chip Stamps v Manor Drug Stores* 421 US 723 (1975) and the discussion in *Loss & Seligman (1995)* at 955-6.

<sup>11</sup> For support see *Langevoort (1993)*.

## 9.2 SUMMARY OF THE REGULATORY PROVISIONS

Historically the Australian securities laws had only imposed liability on an advisor if that person was an “expert” who had prepared a report for inclusion in the prospectus. Expert liability for prospectus misstatement has been a feature of the securities laws in Australia for some time. The genesis in the Commonwealth context was the recommendations in England of the 1945 Cohen committee.

Prior to the recommendations of the Cohen committee a director had an expertisation defence for statements made on the authority of an expert but there was no explicit liability imposed on the expert for those statements.<sup>12</sup>

The Cohen committee considered that an expert responsible for a report included in a prospectus who has consented to its inclusion should be liable to investors unless the expert could show that he had reasonable grounds for believing the statement to be true until the time of allotment.<sup>13</sup> On the other hand, the Cohen committee did not believe that it would be appropriate to impose civil liability on professional advisors who might be named in the prospectus but who did not prepare separate reports, such as bankers, brokers, solicitors and accountants.<sup>14</sup>

These recommendations were reflected in the English companies legislation and ultimately found their way into the *Uniform Companies Act* 1961 of Australia.<sup>15</sup> That remains the case in most other Commonwealth jurisdictions<sup>16</sup> and the case in the United States.<sup>17</sup>

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<sup>12</sup> This obvious deficiency had been observed by the United States draftsman and remedied in the drafting of section 11 of the *Securities Act* 1933 - see the discussion in *Douglas & Bates (1933)* at 197-8.

<sup>13</sup> See paragraphs 38 and 44 of the *Cohen Committee Report*. The question of sharing of liability among persons responsible for prospectus misstatement received specific recognition by the Cohen committee who recommended an extension of rights of contribution to the expert who might face liability.

<sup>14</sup> While it was recognised the naming of professional advisors might lead many investors to think those persons are recommending the investment it was concluded, without any policy analysis, that it would not be justifiable to impose prospectus liability on them (at paragraph 46).

<sup>15</sup> For an example of the traditional formulation in these terms see section 107(2) of the *Companies Code* 1981.

<sup>16</sup> See for example in the United Kingdom (section 90 of the *Financial Services and Markets Act* 2000 and regulation 14 of *The Public Offer of Securities Regulations* 1995) and in New Zealand (section 57 of the *Securities Act* 1993). See *Turner* (1989) at 3 for arguments in favour of direct liability.

In the United Kingdom paragraph 6(4) of the *Financial Services and Markets Act* 2000 (Official Listing of Securities) Regulations 2001 specifically provides that nothing in that regulation (which specifies the persons facing civil liability) is to be construed as making a person responsible for any particulars by reason of giving advice as to their contents in their professional capacity.

<sup>17</sup> Section 11(a)(4) of the *Securities Act* 1933.

Australia is the only significant jurisdiction that purports to impose primary civil liability on advisors more generally for the contents of offer documents.<sup>18</sup>

### **Background to *Corporations Law***

The *SIRC Report* had not suggested advisor liability was appropriate. Its only recommendation was an extension of civil liability to specifically cover underwriters and brokers.

However, the Explanatory Memorandum to the *Corporations Bill 1988* suggested that by imposing specific liability on advisors, prospectus integrity would be enhanced through the imposition of liability on all persons involved in prospectus preparation.<sup>19</sup>

As such, it would seem that the *Corporations Bill* based the extension of liability on gatekeeper policy grounds. While the Senate Review Committee noted concerns that imposing primary liability on advisors might be expanding the net of liability too broadly, the view was expressed that an appropriate balance had been introduced by the *CL*.<sup>20</sup> Reference was made to the public concern generated by the expansion in the class of professionals facing liability under the provisions of the *Corporations Bill*. The example was given of a solicitor named in the prospectus potentially having liability for an expert geologist report in the document. The Senate Review Committee commented:

“This interpretation of the law appears not to be correct. A proper reading of part 7.11 and 7.12 show that a professional who contributes to preparation of the prospectus can only be held liable for his own input... nevertheless, whilst some exaggerated views as to the liability of experts may be discounted, there is not doubt that they carry a heavier responsibility than applies under the Code”.

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<sup>18</sup> The exception is Singapore that copied the Australian regime in 2001 (see section 55(3)(e) of the *Companies Act (CAP 50)*).

<sup>19</sup> Paragraph 2996 of Explanatory Memorandum to *Corporations Bill 1988*.

“By expanding the range of persons who may be held liable for “defective” prospectus it is sought to provide another means in the Bill of ensuring prospectus integrity. The Bill aims to make all persons involved in the preparation of a prospectus responsible for the prospectus. At the same time it can be noted that the provision does not act indiscriminately or unfairly. Each of the persons who may be liable under *CL*. 1005 is provided with a defence and in general will only be liable if they have not exercised due diligence”.

<sup>20</sup> Paragraph 10.28 - 10.30 of *Report of the Joint Select Committee on Corporate Legislation* (April 1989, AGPS)

Because of the confusion arising in relation to the liability of named professionals the Senate Review Committee recommended the prescription of standard forms of disclosure setting out the liability attaching to each class of professional advisor.<sup>21</sup> That practice did not develop.

### Advisor Liability Before the CLERP Act

Looking at the position of the advisor more generally following the enactment of the *Corporations Law*, the pre-CLERP *Corporations Law* imposed a very complicated regime in relation to advisors. A short technical analysis of the pre-CLERP CL position highlights that complexity.

In the criminal context, advisors would face liability if they could be considered to “authorise or cause the issue” of a prospectus or if they were involved in a misstatement as an accessory. As discussed in Section 2.1 above, the term “authorise or cause the issue” gave rise to problems of indeterminacy when applied to advisors. The decision of *Morgan v NRMA*<sup>22</sup> suggested an advisor would not face liability on that basis.<sup>23</sup>

In the civil context, advisors faced a regime of deemed liability, subject to certain responsibility limitations and naming limitations. In addition, the advisor had available to them a traditional due diligence defence.

The Pre-CLERP CL imposed liability for any misstatement on the following three categories of advisor named in the prospectus:

- as a category - experts.<sup>24</sup> This corresponded to the original securities law requirement (although extending potential liability to the entire prospectus, subject to the following);
- as a category - auditors, bankers or solicitors of the issuer or for or in relation to the issue;<sup>25</sup>

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<sup>21</sup> Recommendation 21 Ibid.

<sup>22</sup> *NRMA Ltd & Ors v Morgan & Ors* (1999) 31 ACSR 435 (SC NSW, Giles J); [2000] NSWCA 374; 36 ACSR 462 (Malcolm AJA, McPherson AJA, Ormiston AJA).

<sup>23</sup> See analysis at section 2.1

<sup>24</sup> Pre-CLERP CL section 1006(2)(e). The term expert was broadly defined in section 9 to mean “a person whose profession or reputation gives authority to a statement made by him or her in relation to [a] matter”. CL 1032 provided that a prospectus could not be issued containing a statement made by an expert or based on a statement made by an expert unless consent was obtained and disclosed in the prospectus.

<sup>25</sup> CL section 1006(2)(g).

- as a category - persons performing a function in a professional, advisory or other capacity for the issuer or for or in relation to the issue.<sup>26</sup>

These categories expanded the list of advisors well beyond those directly involved in the prospectus preparation process as was intended by the background materials to the *Corporations Law*. As such the legislation was very poorly drafted in its objective of targeting the relevant advisors involved in the prospectus preparation process. This is illustrated by the following points.

First, the expert definition was based on the person's profession or reputation giving authority to a statement made in the prospectus. There was no requirement that an expert report would need to be included in the prospectus,<sup>27</sup> the traditional trigger for expert liability. The category of named auditors, bankers, and solicitors of the issuer or involved in the issue did not necessarily equate to any involvement in the prospectus preparation process. Again, the consequence was such persons may not be performing a gatekeeper function in relation to the offering.<sup>28</sup> Similarly, the final category of advisor, being persons otherwise performing some other function, was inherently uncertain and, again, not necessarily directed to those performing any gatekeeper role in relation to the offering.<sup>29</sup>

The potentially overbroad categorisation of those facing potential advisor liability was somewhat ameliorated by the responsibility limitation set out in the *CL* section 1009(2) of the *CL* that restricted liability for advisors to those parts of the prospectus for which the advisor was

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<sup>26</sup> *CL* section 1006(2)(h).

<sup>27</sup> Examples of circumstances where the expert definition would be triggered would include:

- a prospectus referring to the credit rating a credit rating agency has given the issuer;
- a reference in the prospectus to statistical information prepared by a third party (for example the Government Bureau of Statistics or industry survey information).

This caused practical difficulties for issuers in that they would not necessarily have any relationship with the expert and may face difficulty in obtaining the required consent, particularly if the expert was conscious of the potential liability consequences.

<sup>28</sup> A further observation is that the category did not seem particularly sensitised to the tasks performed by the different advisors listed. For example "bankers" (in Australia traditionally referring to persons performing trading bank functions as distinct from investment bankers) rarely have little to do with an offering. Further the "auditor" is not necessarily the accountant performing the accounting review functions in relation to the offer in Australia.

<sup>29</sup> For example:

- It would be necessary that the prospectus refer to the registrar who would maintain the register of the securities to be issued. The registrar would have no involvement in prospectus preparation but, as a practical necessity, would need to be named in the prospectus.
- Any trustee for debenture holders or holders of prescribed interests would need to be named in the prospectus. While the trustee has an important function within the regulatory scheme, that function does not necessarily extend to ensuring the accuracy of the information included in the prospectus.

“responsible”.<sup>30</sup> In relation to each category of advisor, the advisor would only be liable in respect of a false or misleading statement in the prospectus purporting to be made by the advisor or to be based on a statement made by the advisor.<sup>31</sup> The operation of the responsibility limitation was ambiguous where an advisor might have had primary responsibility for preparing part of a prospectus, but did not assume responsibility for that disclosure in the prospectus.<sup>32</sup>

In relation to omissions, the position of experts was distinguished from specified professionals and other professionals. An expert would only be liable for an omission of a matter from a statement purporting to be made by the expert as an expert, or based on a statement made by the expert as an expert.<sup>33</sup> Other professional advisors would only be liable for omissions where the advisor was responsible for that matter in its capacity as that advisor or its purported capacity as that advisor.<sup>34</sup> Presumably the legislative draftsman had intended that regard should be had to the actual function performed by the advisor in determining if there should be liability for omissions. However (again) the difficulty was that there was no regard in the legislation to the concept of delegated inquiry functions that form the basis of prospectus preparation.

In seeking to assess the position of the advisor in relation to the above matters, it is helpful to recall the observation of Judge McLean in the *BarChris Case* to the effect that the role of a securities lawyer in preparing a registration statement does not result in the entire document being prepared by that person as an expert, so that the document can be treated as having been expertised.<sup>35</sup> By analogy, an advisor should not be seen to assume responsibility for part of a

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<sup>30</sup> The limitation was not drafted as a defence in the same way as the other defences contained in sub-division 4B of Part 7.11 as the section provided that the advisor “is liable in an action under section 1005 only in respect of” the misstatements identified in the section. An issue would arise as to whether that meant an investor seeking damages under section 1005 would bear the burden of proof in relation to the matter or whether, like the other defences the defendant would bear the burden of proof. There would seem to have been a good argument for suggesting the requirements of section 1009(2) formed an element of establishing the right to damages as against the advisor and therefore the plaintiff would bear the burden of proof.

<sup>31</sup> CL Section 1009(2)(a).

<sup>32</sup> It would seem reasonably clear that where an expert prepared a report for inclusion in the prospectus that expert’s report would be made by the expert within the meaning of the section. Therefore, for example, the accountant would be responsible for its separate investigating accountant’s report. However the position would be much less clear in relation to other parts of the prospectus. For example, it is customary for the investigating accountant to verify the financial data contained in the general parts of the prospectus. It would seem that the investigating accountant could claim that it was not responsible for those verified statements on the basis that the person making the statements in the general part of the prospectus is the issuer itself and that financial information is not based on the statements of the investigating accountant because the information is sourced from the issuer itself. The findings of the *BarChris Case* as it relates to the responsibility for the “stub” financial period are supportive of that view - see Section 7.2 at text to footnote 52.

<sup>33</sup> Pre-CLERP CL section 1009(2)(ba).

<sup>34</sup> Section 1009(2)(b).

<sup>35</sup> *BarChris Case* at 683. See also *In re Flight Transportation Corp Securities Litigation* 593 F Supp 612 (D Minn 1984) (giving underwriter legal advice does not result in expertisation of registration statement); *Seidel v Public Service Co of New Hampshire* 616 F Supp 1342 (DNH 1985); *In re ZZZZ Best Securities Litigation* [1989 Transfer Binder] Fed Sec L Rep (CCH) 93,920 (CD Cal). See also *Loss & Seligman (1994)* at 1007.

prospectus merely because the advisor assisted in the preparation of that part. Ultimately the disclosures are disclosures of the issuer, not the advisor.<sup>36</sup> It also follows that the lawyer has no liability as an expert in relation to its involvement in the preparation of the disclosure document under United States law.<sup>37</sup>

In addition, to the responsibility limitations of the Pre-*CLERP CL*, the advisor had available to it the possibility of naming limitations. Pre-*CLERP* section 1010 of the *Corporations Law* provided that an advisor who was “named in part only” of a prospectus would not be liable for a misstatement if it was proved that the statement was not included in or omitted from that part of the prospectus or was not included in the form and context that the person had agreed to, provided the prospectus included an express statement that the advisor was involved only in the preparation of that part of the document.<sup>38</sup> This defence was not available to an expert. The concept of being “named in part only” of a prospectus was inherently ambiguous. The legislation provided no guidance as to what was intended.<sup>39</sup>

The combination of the deemed liability regime, the responsibility limitations and the naming limitations clearly established a very cumbersome liability structure for the advisor. The securities market could have been forgiven in 1990 for being concerned advisors faced a substantial regime of potential liability that needed to be guarded against.<sup>40</sup> However, the above analysis suggests that the 1989 Senate Review Committee observations are likely to have reflected the correct legal conclusion on the position of an advisor.

The fundamental difficulty with the pre-*CLERP CL* provisions was that the legislative draftsman had not been sensitive to the actual role performed by various participants in the capital raising process in clearly delineating the intended scope of liability. The legislative history was also completely unhelpful in providing any guidance as to where the boundaries of liability should lie.

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In the United States the SEC has also entered the debate by refusing to permit the business description of a registration statement to be expertised.

<sup>36</sup> In the absence of an express assumption of responsibility disclosed in the prospectus.

<sup>37</sup> For discussion see M.V. Freeman “*Liability of Counsel For Issuer*” (1969) *Bus Law* 635 at 636-7.

<sup>38</sup> CA Section 1010(2).

<sup>39</sup> See text accompanying footnote 33 of Chapter 4 for discussion.

It is difficult to reconcile the naming restriction with the responsibility restriction. Surely if the advisor is responsible for part only of the prospectus his liability will be limited to that part by application of section 1009. As such there would be no need for reliance on the additional mechanism of section 1010.

<sup>40</sup> See for example J. Steven “*Fundraising: Advisors in the Hot Seat*” (1988) 13 *Butterworths Company Law Bulletin* para 299.

Beyond the analysis of potential liability set out above, the pre-*CLERP CL* incorporated a due diligence defence for the advisor couched in the traditional inquiry terms of:

“after making such inquiries (if any) as were reasonable, had reasonable grounds to believe”.

The relevant belief in the case of statements was that the statement was true and not misleading, and in the case of omissions that there were no omissions from the statement (in the case of statements made by an expert) or, in the case of specified professionals and other professionals, there were no omissions from the prospectus of matters for which the person was responsible.<sup>41</sup>

An interesting addition to the due diligence defence for an advisor was that the advisor was required to prove that it was “competent to make the statement”.<sup>42</sup> As such it was as if a presumption of incompetence was assumed by the legislative scheme that that would require contrary evidence from the advisor.

### The CLERP Act re-write

The *Simplification Task Force* would seem to have considered (correctly, consistent with the above analysis), that the pre-*CLERP Corporations Law* provisions relating to advisor liability could be significantly simplified and clarified.<sup>43</sup>

The *Simplification Task Force* therefore recommended that it be made clear that the liability of persons concerned in the capital raising process be related to the extent of their involvement in the preparation of the prospectus.<sup>44</sup>

In the *CLERP Act* review, the ambiguities surrounding the liability of advisors were perceived to result in increased costs for capital raising.<sup>45</sup> This was considered to be a further reason to clarify the potential liability of advisors.<sup>46</sup> It was considered that the pre-*CLERP CL* did not clearly limit

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<sup>41</sup> Section 1009(3)(c) in the case of experts and section 1009(4)(b) and (c) in the case of specified professionals and other professionals.

<sup>42</sup> Or, in the case of a specified professional or other professional in relation to an omission, “competent to act in that capacity” (section 1009(4)(c)).

<sup>43</sup> *Simplification Task Force Report on Fundraising* at 16.

“persons who are named as bankers, auditors and solicitors of the corporations or in relation to the issue generally do not make specific statements in the prospectus as appears to be contemplated by sub-section 1009(2). Nor is there involvement generally limited to part only of the prospectus as contemplated by sub-section 1010(1)”.

<sup>44</sup> See proposal 25(b) and (c) of the *Simplification Task Force Report on Fundraising* at 7.

<sup>45</sup> *CLERP Fundraising Paper* at 47.

<sup>46</sup> Proposal No.14 of *CLERP Fundraising Paper* at 48:

liability to statements of opinion on specific matters and was unclear as to whether it extended liability to all parts of the prospectus on which advice was given. It was said:

“it is likely professional advisers adopt a cautious approach by assuming that they may be joined in any action on a misleading prospectus and may be found liable for any defects. They may therefore seek to verify parts of the prospectus which they would not otherwise consider (and which may not fall within their professional expertise) and ensure that all parts of the prospectus make very detailed disclosure. This would in turn contribute to the cost of undertaking due diligence and could contribute to the length and complexity of the prospectus.”

It would seem that these concerns were slightly exaggerated. No evidence was cited (actual or anecdotal) to suggest advisor caution led to increased costs of fundraising or excessive verification in the pre-*CLERP CL*. Concerns of excessive liability had been raised and rejected by the Senate Review Committee in 1989 as being an incorrect interpretation of the law. There was no suggestion in the materials that advisors had a different view of the law.

It would seem that the best reason for the *CLERP Act* reform was the interests of simplification, without any significant change in the liability position faced by the advisory or impact on due diligence practices that are adopted in fundraising.

Following the enactment of the *CLERP Act* the *Corporations Act* only imposes liability on persons named in the disclosure document with their consent as having made a statement that is included in the disclosure document or on which a statement made in the disclosure document is based.<sup>47</sup> Such a person only faces liability for loss or damage caused by the inclusion of the particular statement in the disclosure statement, rather than for the prospectus generally. The person has available to them the general due diligence and reasonable reliance defences available in relation to that potential liability.

Of course, the advisor may also face potential secondary accessorial liability in connection with their conduct in relation to the preparation of the offering document.<sup>48</sup>

The popular perception with the enactment of the *CLERP Act* provisions was that the potential liability of advisors was being significantly reduced from that existing under the Pre-*CLERP*

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“Professional advisers and experts should be liable to investors only for misleading statements attributed to them in the prospectus (subject to the uniform defence ....)”

<sup>47</sup> Section 729(1), Item 5. See also paragraph 8.31 of the Explanatory Memorandum to the *CLERP Bill* which merely re-stated this proposition.

<sup>48</sup> As is made clear by section 729(1), Item 6.

*Corporations Law*. However, the above analysis would suggest that the distinction is more cosmetic than fundamental.

### Comparison with the United States

It is interesting to undertake a comparative analysis between the Australian regime and the United States regime. In the United States, advisors do not face potential primary liability for prospectus misstatement under section 11 of the *Securities Act* 1933 because they are not named as having primary liability.<sup>49</sup> Advisors will not be considered experts merely because, for example they have acted as lawyers and assisted in drafting the prospectus.<sup>50</sup> Further, there is no accessory liability under section 11.<sup>51</sup>

Similarly, advisors do not face potential primary liability for prospectus misstatement under section 12(2) of the *Securities Act*, as they are not “sellers” for purposes of this section.<sup>52</sup> They do face potential accessory liability under this section.

Lawyers practicing in the securities law area have faced the prospect of administrative disciplinary proceedings before the SEC if they are involved in activities that are considered unprofessional in connection with prospectus preparation.<sup>53</sup> Similarly, accountants certifying

<sup>49</sup> Section 11(a)(1) to (5) of the Securities. See *Herman & MacLean v Huddleston* 459 US 375 (lawyers not acting as an expert generally cannot be reached by a section 11 action - at 386 note 22).

<sup>50</sup> See *BarChris Case* at 683 (discussed at text accompanying footnote 51 in Section 7.2); *ZZZZ Best Securities Litigation* [1989 Transfer Binder] Fed Sec L Rep (CCH) 94,485 (CD Cal 1989) (an opinion regarding the legality of the offering does not constitute an expertised portion of the registration statement); *In Re Flight Transportation Corp Securities Litigation* 593 F Supp 612 (D Minn 1984); *Kitchens, et al v US Shelter, et al* [1988 Transfer Binder] CCH Fed Sec L Rep 93,920 (DSC).

The effect of issuing legal opinions in connection with securities transaction has been a particularly contentious issue. Under United States law a registration statement must contain an opinion of counsel on the validity of the securities to be issued - see discussion in *Small (1973)* at 1192-3; D.A.Rice & M.I.Steinberg “*Legal Opinions in Securities Transactions*” (1991) 16 Jnl of Corp L 375 at 405-426 and *Wenner (1988)* at 61-3 and 73-5. This is not a requirement of Australian law so no analogy arises for purposes of this dissertation.

As such, the United States position is quite different to Australia in that the lawyer does not need to lodge any work product.

<sup>51</sup> *In Re Flight Transportation Corp Securities Litigation* 593 F Supp 612 (D Minn 1984); *In re Equity Funding Corp of America Securities Litigation* 416 F Supp 161 (CD Cal 1976); *Kitchens, et al v US Shelter, et al* [1988 Transfer Binder] CCH Fed Sec L Rep 93,920 (D SC)

As a reaction to the continued narrowing of the class of plaintiff recognised by the United States courts in securities laws matters the *Securities Act* was amended in 1995 by the *Private Securities Litigation Reform Act* to provide the SEC with the power to bring action against an accessory “that knowingly provides substantial assistance to another person” (section 20(f)).

<sup>52</sup> *Pinter v Dahl* 486 US 622 (1988).

Again, this is now subject to the SEC’s rights under section 20(f) of the *Securities Act*.

<sup>53</sup> Under the SEC’s enforcement authority and under Rule 102(e) of the SEC’s Rules of Practice (17 CFR SS 201.2(e)). For example see *SEC v National Student Marketing Corp* 457 F Supp 682 (DDC 1978) (no injunction even though violation established by lawyers issuing improper legal opinions); *SEC v Spectrum Ltd* 489 F 2d 535 (2nd Cir 1973) (similar); *In Re Carter & Johnson*, SEC Release No. 34-17597 [1981 Transfer Binder] Fed Sec L Rep (CCH) 82,847 (Rule 2(e)).

For discussion generally see *Albioni (1981)*.

financial statements are subject to the prospect of administrative disciplinary proceedings before the SEC for unprofessional conduct.

In the absence of clear rights of action against deep pocket advisors based on the *Securities Act* provisions, the professional plaintiff bar in the United States have sought to pursue more exotic claims of action against advisors in recent years, such as common law fraud and negligence with mixed success.<sup>54</sup>

### 9.3 ASSESSMENT OF THE POSITION OF ADVISORS

The advisor who has consented to being named in an offering document will face potential primary civil liability for statements made by them in the offering document or for statements in the offering document which are based on a statement made by them.<sup>55</sup> The liability relates to any misleading or deceptive statement or an omission from the disclosure document of material required by the CA to be included in the offering document that is relevant to that statement of the advisor.<sup>56</sup>

The advisor will have a due diligence defence and a reasonable reliance defence in relation to that potential liability.<sup>57</sup>

In other respects (civil liability for other statements and criminal liability) the advisor will face potential accessory liability.

#### Persons Liable

The reformulated liability extends to statements of any person, not just professional advisors or “experts” as previously defined.

#### Statements that give rise to liability

Under the *Corporations Act* the statements giving rise to potential liability are those attributed to the advisor or “based on a statement made by” the advisor.

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<sup>54</sup> See discussion in *Donohue (1990)* at 120-129

<sup>55</sup> CA section 729(1), Item 5.

<sup>56</sup> CA section 728(1)(a) and (b)

<sup>57</sup> CA section 731 and section 733. Also relevant to the advisor are the lack of knowledge defence in CL section 732 for an Offer Information Statement or Profile Statement.

An area of uncertainty exists in determining when a statement in the offering document is based on a statement of an advisor.

It can be argued that *CA* section 729(1), Item 5 requires that the relevant consent is a consent to the inclusion of the statements that give rise to primary potential liability, not just consent to the advisor being named in the offering document.<sup>58</sup> If this is so, it will be a relatively simple task to determine the statements that give rise to potential liability. Alternatively, it will be necessary to determine if a named advisor is the source of a statement. This would give rise to some of the difficulties arising with the pre-*CLERP CL* described above in defining what statements give rise to potential liability.

The former interpretation should be preferred over the latter as it gives rise to greater clarity and is consistent with the expressed objectives of the reformulated legislation, as outlined above.

A further area of potential uncertainty is in determining when an omission will arise in relation to a statement for which the advisor has potential liability. The better view should be to have regard to the case law on false impression and half truth tested by reference to the statements in question.<sup>59</sup>

### **Expected Standard of Conduct**

The question then becomes what standard of conduct will be required of the advisor in order to make out its due diligence and reasonable reliance defences under the *Corporations Act*.

As there is no history of litigation under the *CA* against advisors and the *CA* has been the only statutory provisions to impose primary liability, subject to a due diligence defence, on advisors in any significant jurisdiction it is necessary to turn to first principles to answer this question.

As the regime imposes a statutory standard analogous to negligence, it would be reasonable to impose a standard of care equivalent to negligence on the advisor.<sup>60</sup>

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<sup>58</sup> "a person named in the disclosure document with their consent as having made a statement .... on where a statement made in the disclosure document is based"

<sup>59</sup> See Section 2.4.

<sup>60</sup> See analysis at Section 4.3. For example, one of the draftsmen of the *Securities Act* 1933 of the United States has stated a key objective of the civil liability provisions was to impose on accountants the necessity for independence and a professional approach - *Landis (1959)* at 35.

The standard of care could properly be considered to be an objective standard based on a reasonable person having the skills and experience of a competent advisor performing the role that has been assumed by the advisor in the circumstances of that offering. There is no need to address the objective/subjective debate that is a unique feature of the position of a director as a quasi-fiduciary.<sup>61</sup>

The traditional approach of prospectus case law suggests a level of inquiry is required beyond accepting at face value assertions made by self interested parties and management.<sup>62</sup> The application of those principles to the advisor would be consistent with a gatekeeper function imposed on the advisor. However, in that regard the position of the advisor is more focused than the underwriter and the adversarial/verification role of the underwriter in relation to the entire document should therefore not be applicable.<sup>63</sup>

The liability regime should therefore be considered to create a regime analogous to statutory negligence for the advisor.

The conclusions drawn above are demonstrated by the findings that were made in the United States context in the *BarChris Case*, where the accountant was unable to make out a due diligence defence for the financial information contained in the registration statement on which it had delivered an auditors certificate.<sup>64</sup> The liability of the expert is limited only to the parts of the prospectus prepared by it and not, for example, other parts of the prospectus where it may have assisted in preparation.<sup>65</sup>

In the *BarChris Case*, Judge McLean concluded that the auditors' review of financial information, particularly in relation to its subsequent events review of financial matters for delivering its certificate, was inadequate because it failed to conform to industry accepted

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<sup>61</sup> See the debate in Section 7.3. In the negligence context the standard of care for a person who has a special skill or competence is normally expressed as the standard of an ordinary skilled man exercising or professing to have that special skill - *Bolam v Friern Barnett Hospital Management Committee* [1957] 1 WLR 582.

<sup>62</sup> See the lessons of cases such as *J.P. Coats v Crossland* (1904) 20 TLR 800 and *Adams v Thrift*(1915) 1 Ch 557 in this regard, discussed in Section 7.2.

<sup>63</sup> Compare Section 8.3 analysis.

<sup>64</sup> *BarChris Case* at 701-3. The auditor was not found to be responsible under section 11 for any financial information that it had not specifically certified in the prospectus, even though it had verified that information for the issuer.

<sup>65</sup> *BarChris Case* at 697-8. See also *Kitchens, et al v US Shelter, et al* [1988 Transfer Binder] CCH Fed Sec L Rep 93,920 (D SC).

practice standards and failed to satisfy its own firm's standard for review.<sup>66</sup> However, it was said that:

“Accountants should not be held to a standard higher than the recognized in their profession”.<sup>67</sup>

As such, there was a close corollary between the approach of the United States court and the approach an Australian court would adopt in assessing breach of a duty of care for purposes of a negligence action.

The approach of the *BarChris Case* in accepting industry accepted practice standards as determinative of satisfaction of the due diligence defence has been criticised for effectively delegating authority for that determination to industry bodies, with the potential effect that it could afford incentives to ease liability by lowering professional standards.<sup>68</sup> That criticism would seem soundly based. An Australian court would be unlikely to accept unqualifiedly that relevant professional standards are determinative of whether a duty of care has been established. More recent United States courts have suggested that complying with generally accepted standards will not protect the accountant where the accountant knows or recklessly fails to uncover relevant facts.<sup>69</sup>

#### 9.4 ADVISORS AS ACCESSORIES

In addition to the above analysis of the primary liability provisions, the advisor will also face potential accessory liability.<sup>70</sup> As has been noted in Chapter 2 and Chapter 3, general accessory liability arises in the same terms:

- for criminal liability under section 11.2 of the *Criminal Code*;
- for civil liability under section 729 of the *CA* by virtue of the definitional provisions of section 79 of the *CA*.<sup>71</sup>

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<sup>66</sup> Ibid at 701.

<sup>67</sup> Ibid at 703.

<sup>68</sup> *Folk 1 (1969)* at 62. For criticism of the objectivity of accounting principles see *Margolis (1979)* at 400-1 and *Kripke (1979)* at Chapter 15.

<sup>69</sup> *Admiralty Fund v Hugh Johnson & Co* 677 F 2d 1301 (9th Cir 1982) at 1313; *Ahern, et al v Gaussoin, et al* [1985 Transfer Binder] CCH Sec L Rep 92,332 (DO).

Accessory liability falls for consideration in this chapter because of its relevance to the advisor, who has not assumed responsibility for a particular statement in an offering document, but who has been involved in the capital raising process. However, under the *Corporations Act* accessory liability analysis is also relevant to management of the issuer and underwriters (in particular).

The key distinction between criminal and civil accessory liability will of course be the burden of proof that applies. In other respects the case law establishes that the same legal principles of liability apply.<sup>72</sup> As has been stated by the High Court in relation to accessorial liability for civil liability under the Trade Practices Act:

“[The section] operates as an adjunct to the imposition of civil liability, its derivation is to be found in the criminal law and there is nothing to support the view that the concepts which it introduces should be given a new or special meaning”.<sup>73</sup>

It must be anticipated that precisely the same approach to accessory liability will be adopted in relation to section 79 of the *Corporations Act*.

It will be noted that the relevant statutory provisions contains four alternative elements:

- aid, abet, counsel or procure a contravention;
- induce a contravention;
- knowingly concerned in or party to a contravention; or
- conspire with others to effect a contravention.

Each of these elements are addressed in turn.

### **Aiding and Abetting Liability**

Case law establishes that aiding and abetting liability requires evidence of the following matters :

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<sup>70</sup> Liability on this ground is illustrated by the criminal proceedings against the solicitor and accountant involved in an IPO in *Cwth DPP v Stevenson & Smithers* (unrep, 17 October 1994) (Local Court, Sydney).

<sup>71</sup> Which is itself identical to the formulation of accessory liability under section 75B of the *Trade Practices Act for Misleading & Deceptive Conduct Liability*.

<sup>72</sup> As demonstrated by the High Court adoption of the same analysis in the two 1985 decisions of *Giorgianni v The Queen* (1985) 156 CLR 473 (section 5 of the *Crimes Act 1914*) and *Yorke & Anor v Lucas* (1985) 158 CLR 661 (section 75B of the *Trade Practices Act*).

<sup>73</sup> *Yorke v Lucas* Ibid at 669 (Mason ACJ, Wilson J, Dean J, Dawson J).

- the accessory helped encourage or induced a principle offender to commit the offence;<sup>74</sup> and
- the accessory knew the essential matters which constituted the offence.<sup>75</sup>

The key terms used in the relevant statutory provisions are “aiding”, “abetting”, “counseling” and “procuring”. Those terms have been part of the criminal law for many years.<sup>76</sup> In *Giorgianni v The Queen* it was noted that the meaning of those words overlap and any historical distinction between the terms are now of no importance.<sup>77</sup> As such, the phrase is an obvious candidate for simplification.

The first element of the offence is the requirement of participation. It has long been a feature of the law of accessory liability that the accessory must perform an act which in some way assists the contravention of the offence in question. In *Giorgianni v The Queen* Gibbs CJ said that the accessory must:

“In some sort to associate himself with the venture, that he participate in it as something that he wishes to bring about, that he seek by his action to make it succeed”.<sup>78</sup>

As such, it can be argued that something more than passive acceptance of the existence of disclosures in a prospectus is required in the securities law context. The key issue will be whether this requirement will be satisfied in the prospectus preparation process by membership of the due diligence committee or by otherwise accepting responsibility in relation to the preparation of relevant parts of a prospectus.

In the United States, participation is also required for accessory liability.<sup>79</sup> In that context it has been held in a number of cases that where a lawyer participates in the drafting of disclosures

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<sup>74</sup> See *National Coal Board v Gamble* [1951] 1 QB 11.

<sup>75</sup> *Johnson v Youden* [1950] 1 KB 544; *Giorgianni v The Queen* supra; *Yorke v Lucas* supra.

<sup>76</sup> The references in section 11.2 of the *Criminal Code* (and before it section 5 of the *Crimes Act* 1914) originally derive from section 8 of the *Accessories and Abettors Act* 1861 (England) - see *Black (1994)* at footnote 23.

<sup>77</sup> *Giorgianni* case at 480-1 (Gibbs CJ) and 493 (Mason J).

<sup>78</sup> *Giorgianni* case citing *United States v Peoni* 100 F 2d 401 (2nd Cir, 1938). See also *Sent v Jet Corp of Australia Pty Limited* (1984) 54 ALR 237 (FCA Full Court).

This is reinforced in section 11.2(2)(a) of the *Criminal Code* which provides that for a person to be guilty the person's conduct must have “in fact” aided, abetted, counselled or procured the commission of the offence by the person primarily liable. In section 11.2(3)(b) recklessness about the commission of the offence is also sufficient participation.

<sup>79</sup> Aiding and abetting liability for securities law violations in the United States are similarly based on criminal law (and related tort law) theories - see *Bromberg & Lowenfels (1991)* at 646-7; *Doherty (1992)* at 832-7; *Langevoort (1993)* at 84 - 89.

contained in a registration statement which are misleading, that would constitute a sufficient level of participation in a contravention of the securities laws for purposes of accessory liability.<sup>80</sup> On the other hand, a lawyer who does not prepare disclosure documents but who merely provides general advice or more routine services will generally not face liability as one who has participated in a contravention of the securities laws.<sup>81</sup> Similar principles have been applied in the United States in relation to accountant's activities in certifying financial information in a registration statement.<sup>82</sup>

The requirement of a level of participation beyond knowledge has recently been explicitly recognised in the security law context in Australia in *NRMA v Morgan*.<sup>83</sup> It was alleged in this case that the legal advisors and legal counsel providing written advice in connection with a prospectus were involved in a civil contravention of the *Misleading & Deceptive Conduct Provisions* of the *Trade Practices Act* and the *Fair Trading Act*.<sup>84</sup>

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The normal requirement is that there be "substantial assistance" - *ITT v Cornfeld* 619 F 2d 909 (2nd Cir 1980) at 922; *Jett v Sunderman* 840 F 2d 1487 (9th Cir 1988) at 1495. Inaction can be considered to be substantial assistance when the accessory has a duty of disclosure - see *Woodland v Metro Bank of Dallas* 522 F 2d 97.

For an illustration of the requirement of participation in the prospectus context see *Laven v Flanagan, et al* 695 F Supp 800 (DNJ 1988) at 809. For discussion see *Bromberg & Lowenfels (1991)* at 701-739; *Doherty (1992)* at 840-1.

<sup>80</sup> See *Kilmartin v HC Wainwright & Co* 580 F Supp 604 (D Mass, 1984); *Andreo v Friedlander Gaines, Cohen, Rosenthal & Rosenberg* 600 F Supp 1362 (D Con 1988); *SEC v Electronic Warehouse Inc* 689 F Supp 53 (D Conn 1988) as examples of this proposition referred to in *Black (1994)* at 391.

For contrary case law see *Abell v Potomac Insurance Co* 858 F 2d 1104 (5th Cir 1988) (underwriter lawyer involved in preparation, did due diligence but did not have liability). See also *Friedman v Arizona World Nurseries Ltd* 730 F Supp 521 (SDNY 1990) and *Burford White Lumber Co v Octagon Properties* 740 F Supp 1553 (WD Okla 1989) (referred to in *Langevoort (1993)* at footnote 39).

As such, the United States case law is quite unclear in its scope.

A distinction should be drawn to advice given to a client where the advice is subsequently found to be wrong - see *In the Matter of William R Carter and Charles J Johnson* [1981 Transfer Binder] Fed Sec L Rep 82,847 (CCH) at 84,167. However, the lawyer has a positive obligation to seek to persuade their client not to undertake illegal activities, including notifying the board (at 84,170).

<sup>81</sup> See *Barker v Henderson, Franklin, Staines & Holt* 797 F 2d 490 (7th Cir 1986); *Bane v Sigmunder Exploration Corp* 848 F 2d 579 (5th Cir, 1988); *Stokes v Lokken*; *Roberts v Peat Marwick Mitchell & Co* 857 F 2d 646 (9th Cir, 1988) cert den 110 S Ct 561 (1989) as examples cited in *Black (1994)* at 391.

<sup>82</sup> See *Rudolph v Arthur Andersen & Co* 800 F 2d 1040 (11th Cir 1986) cert den 480 US 946; *Roberts v Peat Marwick Mitchell & Co* 857 F 2d 646 (9th Cir 1988) cert den 110 S Ct 561 (1989) cited in *Black (1994)* at 391-2.

<sup>83</sup> *NRMA Ltd & Ors v Morgan & Ors* (1999) 31 ACSR 435 (SC NSW, Giles J). This issue was not considered in the appeal where the primary findings of Giles J were overturned: *Heydon & Ors v NRMA Ltd & Ors* [2000] NSWCA 374; 36 ACSR 462.

<sup>84</sup> *Ibid* at 480-1. The alleged involvement was breaches of the duty of care owed to the issuer and failure to correct alleged disclosure deficiencies in the prospectus.

Giles J said that knowledge of the essential facts alone is not sufficient to establish accessory liability and that:

“only in unusual circumstances would an advisor incur accessory liability.”<sup>85</sup>

It was suggested that such an advisor might need to be linked in purpose with the primary offender to give rise to accessory liability.<sup>86</sup> Similarly, in the earlier case of *Forsyth v Rodda*<sup>87</sup> it was suggested that a barrister would only be liable for aiding and abetting liability if that person knowing of the unlawful purpose of the client promotes the unlawful purpose by encouraging that purpose in a manner where the level of participation falls outside normal professional activities.<sup>88</sup>

This case law would suggest a very high level of participation is required before a lawyer or other professional advisor would be found to face liability as an accessory. The degree of participation would seem to be higher than that suggested by some of the United States case law discussed above.

The second element of accessory liability, the requirement that the accessory know of the essential matters which constitute the offence, was clearly established by the High Court in the *Yorke v Lucas* and *Giorgianni* cases:

“A person will be guilty of the offences of aiding and abetting or counselling and procuring the commission of an offence only if he intentionally participates in it. To form the requisite intention he must have knowledge of the essential matters which go to make up the offence whether or not he knows that the matters amount to a crime”.<sup>89</sup>

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<sup>85</sup> Ibid at 794. Giles J referred to the illustration of *Sutton v A.J. Thompson Pty Ltd* (1987) 73 ALR 233 where an advisor had played a significant part in the contravention by withholding financial information from the plaintiff and accepting joint responsibility for false statements about financial matters, with the result that the advisor was found to be an intentional participant in the offence.

Further authority for the requirement of active participation is illustrated by cases such as *Porter v Audio Visual Promotions Pty Ltd & Ors* (1985) ATPR 40-547 (FCA, Smithers J).

For the requirements of active participation in analogous circumstances see *Rv Tannous* (1988) ALR 403 (SC NSW, Street CJ, Lee & Finlay JJ) (criminal prosecution for being knowingly concerned in criminal act); *Ashbury v Reid* [1961] WAR 49.

<sup>86</sup> Noting *Giorgianni v R, Yorke v Lucas* and *R v Russell* [1933] VLR 59 as support for that proposition. See also *Sent v Jet Corp of Australia Pty Limited* (1984) 54 ALR 237 (FCA, Full Court).

<sup>87</sup> *Forsyth v Rodda* (1989) 87 ALR 699.

<sup>88</sup> Similar reasoning has been adopted in relation to the activities of legal advisors in the context of conspiracy claims - see for example *R v Brown & Ors* [1990] VR 820; *R v Tighe & Maher* (1926) 26 SR (NSW) 94. For discussion of these cases see T. Middleton “Liability of Solicitors Under The Corporations Act 1989 (Cwth)” (October 1992) Qld Law Soc Jnl 429 at 432-3.

<sup>89</sup> *Yorke v Lucas* supra at 667 (Mason ACJ, Wilson J, Deane J, Dawson J). See also *Giorgianni v The Queen* supra at 505 (Wilson, Deane, Dawson JJ). For an example these principles applied in the securities law context see *Von Lieven v Stewart* (1990) 21 NSWLR 52.

As such, there is no necessity to prove that it was known that the facts in question constitute a contravention of law, merely that all the facts required by the prosecution to establish the offence are known by the defendant.

In the securities law context this will be quite a critical issue. In many cases, it is likely that due diligence enquiries will have established the existence of an issue for potential disclosure, but the true nature of that issue could not be quantified at the relevant time of preparation of the prospectus. For example, if an advisor was aware that there was an unresolved piece of litigation but believed in good faith that it was not material for disclosure in the prospectus, the question arises as to whether accessory liability would arise if liability in relation to the litigation is ultimately significant larger than anticipated. This type of situation does not constitute knowledge of essential facts for purposes of accessorial liability as all relevant facts are not known at the time.

A relatively contentious issue remains as to the level of knowledge required to constitute knowledge within the meaning of the above tests. The High Court has been less than clear on this issue. In earlier English cases it had been suggested that where an accessory is put on notice of the existence of relevant facts but willfully closes their eyes to those matters liability will still arise<sup>90</sup> and possibly that consequence will arise where the accessory refrains from making enquiry where a reasonable person would have made enquiry.<sup>91</sup>

In the *Giorgianni case* the Chief Justice said:

“Suspicion of the existence of facts, although relevant when the accused has deliberately shut his eyes, does not by itself amount to or take the place of knowledge for present purposes.... Recklessness, in the sense of not caring whether the facts exist or not, would be relevant only if it to was virtually equivalent to knowledge, in other words only if it amounted to willful blindness”.<sup>92</sup>

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<sup>90</sup> *Johnson v Youden* supra.

<sup>91</sup> *Davies Turner & Co Limited v Brodie* [1954] 3 All ER 283 at 286.

<sup>92</sup> *Giorgianni v The Queen* supra at 487. See also at 482 and the reference to “The failure to make such enquiries as a reasonable person would have made is not equivalent to knowledge” - presumably overruling *Davies Turner & Co Limited v Brodie*.

See also *Wilson Dean & Dawson JJ* at 506-7 “it is not sufficient that knowledge or belief extends only to the possibility or even probability that the acts which he is assisting or encouraging are such as to constitute the factual ingredients or a crime”.

In *Gokora Pty Ltd v Montgomery Jordan and Stevenson Pty Ltd*<sup>93</sup>, Wilcox J referred to a statement of a Brennan J in *Yorke v Lucas* to the effect that honest ignorance of relevant facts could not give rise to liability and said:

“In *Yorke v Lucas* the High Court was not concerned with information given with careless or reckless disregard to the question of truth or falsity.... An assertion of a fact, made in reckless indifference to its truth or falsity, cannot easily be regarded as being the produce of “honest ignorance.”

On the other hand Cole J of the New South Wales Supreme Court said in *Crocodile Marketing Ltd v Griffith Vintners Pty Ltd*<sup>94</sup>:

“*Yorke v Lucas* establishes that there is a requirement of knowledge of falsity and thus to have been involved intentionally in the contravention.... Absence of knowledge, save perhaps in the exceptional circumstances of ignorance being dishonestly maintained, denies the necessary intent in regard to contravention.”<sup>95</sup>

Having regard to the mens rea basis of the action under the criminal law, it would seem that the line is most appropriately drawn at wilful blindness rather than any broader concept of recklessness or lack of reasonable care.<sup>96</sup> In the case of security laws issues involving a prospectus, it is quite critical that there be certainty on this point as, if a broader requirement of reasonable care is required, that would essentially be analogous to requiring due diligence on the part of the advisor.

### **Knowingly Concerned in Contravention**

The third limb of the statutory formulation is broadly expressed to extend in any way directly or indirectly to a person being knowingly concerned in or party to a contravention. There is a certain ambiguity to this language which might otherwise have suggested the requirement of knowledge prefacing the word “concerned in” did not qualify the reference to a party.<sup>97</sup> However the High Court has firmly rejected such a proposition in *Yorke v Lucas* bringing the requirements of the third limb of the regime into conformity with the first limb:

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<sup>93</sup> In *Periera v DPP* (1988) 82 ALR 217 the High Court considered that wilful blindness would be relevant to establishing actual knowledge for these purposes.

<sup>94</sup> *Crocodile Marketing Ltd v Griffith Vintners Pty Ltd & Anor* (1990) 91 ALR 273 (SC NSW, Cole J) (a section 52 action).

<sup>95</sup> *Ibid* at 281.

<sup>96</sup> This should be contrasted with United States law where it has been established that a recklessness standard can apply for civil liability in circumstances of a fiduciary relationship, where there is reasonable foreseeability of reliance, where the accessory benefits from the transaction or where the accessory has a duty of disclosure - see *Black (1994)* at 389; *Bromberg & Lowenfels (1991)* at 672-700.

<sup>97</sup> See summary of appellate arguments in *Yorke v Lucas* supra at 662-3.

“There can be no question that a person cannot be knowingly concerned in a contravention unless he has knowledge of the essential facts constituting the contravention... the proper construction of par.(c) requires a party to a contravention to be an intentional participant, the necessary intent being based upon knowledge of the essential elements of the contravention.”<sup>98</sup>

As with the aiding and abetting limb, knowing concern also requires some promotion or association by the accessory with the contravention.<sup>99</sup>

In view of the above analysis there is little practical distinction between the first limb and third limb of accessory liability. The practical issues facing an advisor will be largely the same.

### **Conspiracy and Inducement**

The second and fourth limbs of the accessory liability definition refer to the well known common law concepts of inducement of breach of law and conspiracy.<sup>100</sup> As is made clear in *York v Lucas*, actual knowledge of the primary contravention is an essential element of each of these limbs of the definition.<sup>101</sup>

As the advisor will typically be participating in a contravention, rather than initiating the contravention as is contemplated by conspiracy and inducement, in practice the accessory limbs are likely to be less important than the other limbs of the regime.

### **Accessory Liability Under Section 729**

The analysis above confirms that accessory liability is based on establishment of knowledge of the misstatement and a level of participation in the contravention. Once those criteria are satisfied, liability is established and issues of culpability do not require consideration.

As a result, prior to the enactment of the *CLERP Act*, an advisor faced a choice:

- consent to be named and face potential primary liability subject to the liability regime described above, including the due diligence defence;

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<sup>98</sup> Ibid. See also *Periera v DPP* (1988) 82 ALR 217

<sup>99</sup> See *Ashbury v Reid* [1961] WAR 49; *R v Tannous* (1987) 10 NSWLR 303; *TPC v Australian Meat Holdings Pty Limited* (1988) 83 ALR 299.

<sup>100</sup> For a survey of the relevant principles see B. Fisse “*Howard’s Criminal Law*” 1990.

<sup>101</sup> *Supra* at 664.

- not be named and face potential accessory liability with no due diligence defence if liability as an accessory was established.

That choice is no longer relevant to the advisor for civil liability purposes because, whether or not the advisor is named in the document, accessory liability can arise but the potential accessory has available to it the due diligence and reasonable reliance defences of the *CA*.

This was an intended change to the *CA*. The *Simplification Task Force* had said that a difficulty with the *CL* was the lack of defences for persons who are involved in a contravention by virtue of section 79.<sup>102</sup> While this is a helpful outcome for advisors, it overlooks the fact that defences of this nature are not traditionally available for the knowledge-based concept of accessory liability as used in other contexts.

In exploring accessory liability principles, the High Court has said that issues of culpability do not arise. As such, to some degree the new provisions cut across the philosophical underpinnings of the accessory liability provisions. They are also inconsistent with the manner in which accessory liability operates for other provisions of the *Corporations Act*. This is an odd consequence - particularly as it relates to potential criminal liability where potential accessory liability is a feature of all of the criminal provisions of the *Corporations Act*.

Unlike the other named persons in *CA* s.729, the application of a due diligence defence to an accessory will necessarily arise in circumstances where the person knew all of the circumstances giving rise to the misstatement. Notwithstanding that fact, the due diligence defence and reliance defence can still have application where the person reasonably believed that those circumstances did not give rise to a misstatement (for example that the matter was not material).

At a policy level, accessory liability does impose a degree of gatekeeper liability on participants involved in the capital raising process. However, the analysis above demonstrates that the basic nature of that liability is different to the policy underpinnings of primary liability. Accessory liability does not require affirmative action but instead a passive refusal to facilitate an ongoing offence. True gatekeeper liability as described in prior chapters imposes an active duty to monitor to escape liability.<sup>103</sup>

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<sup>102</sup> *Simplification Task Force Report on Fundraising* at 16.

<sup>103</sup> See *Kraakman (1984)* at 889.

## CHAPTER 10

### JOINT LIABILITY ISSUES

The civil liability regime established by Part 6D.3 of the *Corporations Act* inevitably gives rise to issues of potential joint liability among those participating in prospectus preparation. In addition, the need for resolution of joint liability issues also arises from potential overlapping civil liability regimes, as discussed in Chapter 5. The prospect of joint liability has the result that those with joint liability will need to share that liability in some way among themselves.

This chapter considers issues of joint liability and assesses the position that exists under the *Corporations Act*. It is odd that the *Corporations Act* barely touches on this issue at all. The failure of the *Corporations Act* to provide a regime for dealing with joint liability issues is a demonstration of the poor formulation of relevant policy underpinnings in the *Corporations Act* provisions.

As this issue is little appreciated in the available Australian literature on the prospectus liability debate and as issues of joint liability will be extremely important in any civil litigation that arises in this area, it is considered important to analyse the matter.

#### 10.1 APPLICABLE PRINCIPLES OF GENERAL LAW

In considering the legal issues that are relevant to questions of joint liability under Part 6D.3, it is helpful to identify the relevant general law principles that bear upon the issue. In doing so, it becomes immediately apparent that there is a tension in the way the general law has developed between, on the one hand, an approach that suggests courts should supervise the sharing of joint liability and, on the other hand, an approach that suggests the court should not assist wrongdoers in any way.

#### **Joint and Several Liability Under the Corporations Act**

Part 6D.3 of the *Corporations Act* (and Part 7.11 before it) does not specify the nature of the liability that will exist for more than one person who face civil liability under the legislation for the same loss.

Section 729 of the *Corporations Act* directs that the relevant loss or damage may be recovered from a person referred to in the table set out in the section. The table lists six categories of

person, including persons who are accessories. It follows that the total loss in question may be recovered from each person facing potential liability. It is a basic legal principle that a plaintiff cannot recover more than its total loss from all those who have potential liability. As a consequence the nature of the liability faced by each person with primary or secondary liability under the *Corporations Act* is joint and several.<sup>1</sup>

### The Doctrine of Contribution

A general doctrine of contribution had developed both in law and in equity to assist those who have a joint liability for the same payment. The doctrine has long been part of the law of suretyship, co-insurance and partnership and has been applied in similar areas where different parties may have co-ordinate liabilities.<sup>2</sup> The most authoritative statement of the Australian position is contained in *Albion Insurance Company Limited v Government Insurance Office of New South Wales*.<sup>3</sup> The basis of the right to contribution was put as follows by Kitto J:

“Persons who are under co-ordinate liabilities to make good the one loss (eg sureties liable to make good a failure to pay the one debt) must share the burden pro rata.”<sup>4</sup>

The doctrine of contribution is founded on concepts of natural justice and the principle of equity of “equality is equity”.<sup>5</sup> In addition it has been suggested that it should not be left to a creditor, through selection of the various possible parties to sue, to determine who should pay the liability, as that would permit the creditor to oppress a particular party through selection based on caprice or favouritism.<sup>6</sup>

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<sup>1</sup> Technically “joint” liability arises where there is a common cause of the loss and a common enterprise while “several” liability arises where there is only a common cause of the loss - see J. G. Fleming “*The Law of Torts*” 9th Edition, 1998, Law Book Company at 288 referring to G Williams “*Joint Torts*” 1951 at 1.

The position is the same in the United States - see *In re Intel Securities Litigation* 89 FRD 104 at 111 (ND Cal 1981).

<sup>2</sup> For a comprehensive review see Chapter 10 (“*Contribution*”) of Meagher, Gummow and Lehane “*Equity Doctrines & Remedies*” 3rd Edition, 1992, Butterworths.

<sup>3</sup> *Albion Insurance Company Limited v Government Insurance Office of New South Wales* (1969) 121 CLR 342. In that case a right of contribution was recognised by the High Court as between two insurers who had separately insured the same loss.

<sup>4</sup> *Ibid* at 350. One insurer was liable for loss under a workers compensation policy while the other insurer was liable for loss under a motor vehicle third party insurance policy in connection with damages suffered by an insured person in a car accident.

<sup>5</sup> *Ibid* at 350-1 (Kitto J). See also *Mahoney v McManus* (1981) 36 ALR 545 at 551 (Gibbs) and generally Meagher, Gummow and Lehane (*supra* note 2) at paragraph 1004.

<sup>6</sup> See Meagher, Gummow and Lehane (*supra* note 2) referring to Story “*Commentaries on Equity Jurisprudence*” Third Edition, 1920, at paragraph 493 (also noted by Kitto J in the *Albion* case, *Ibid* at 350).

The right to contribution arises in equity when a liability of one of several persons to pay more than their proportional share has arisen.<sup>7</sup> In many situations, difficult questions will arise in determining if a “co-ordinate liability” has arisen<sup>8</sup> and whether the same loss is involved.<sup>9</sup>

The doctrine of contribution has also been extended to persons with joint liabilities arising as a result of statutory obligations. For example, in *Armstrong v Commissioner of Stamp Duties*<sup>10</sup> stamp duties legislation provided that the donor and donee of a gift were responsible for the payment of stamp duty “jointly and severally”. The court awarded equal contribution as between the donor and donee.<sup>11</sup> A more contemporary illustration of this doctrine in the *Corporations Act* context are the cases of *Spika Trading Pty Ltd v Harrison*<sup>12</sup> and *Street v Retravisio*<sup>13</sup>, where contribution was ordered under the then section 556 of the *Corporations Law* among directors and management in relation to civil liability for insolvent trading.<sup>14</sup> Giles J in *Spika Trading* held that joint and several civil liability under the insolvent trading provision of the *Corporations Law* gives rise to a common obligation apt to attract the doctrine of contribution notwithstanding the section also gave rise to criminal consequences.<sup>15</sup>

In each of the cases referred to above, contribution was awarded on a pro rata basis. That will generally be the case where parties have an equal responsibility for the loss. However, more complex issues arise where the parties have co-ordinate liabilities of a differing quantum.<sup>16</sup>

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<sup>7</sup> At law the right only arose when payment had been made - *Davies v Humphries* (1840) 151 ER 361 (at law); *Wolmerhausen v Gullick* [1893] 2 Ch 514 (in equity); *Albion case* Ibid at 351-2.

<sup>8</sup> In the *Albion case*, the Supreme Court of New South Wales had denied contribution as the two policies were considered not to have insured the same risk because one policy was for workers compensation and the other was for personal injury. The High Court rejected that conclusion on the basis that payment under both policies covered the same loss - see Ibid at 346 (Barwick CJ, McTiernan J and Menzies J).

<sup>9</sup> See Meagher, Gummow and Lehane (supra note 2) at paragraphs 1012 et seq.

<sup>10</sup> *Armstrong v Commissioner of Stamp Duties* (1967) 69 SR (NSW) 38. See also *Gadsden v Commissioner of Probate Duties* [1978] VR 653.

<sup>11</sup> It had been argued in that case that contribution could only be ordered where the debt is created by a voluntary act of the debtor and not by way of compulsion under a revenue law. That argument was rejected on the basis that contribution does not depend on contract but principles of equity and natural justice - Ibid at 43.

<sup>12</sup> *Spika Trading Pty Ltd v Harrison* (1990) 19 NSWLR 211 (Giles J). To similar effect see *Australian Securities Commission v Snellgrove & Anor* (1992) 10 ACLC 1,542 (SC(SA)) at 1,555-6.

<sup>13</sup> *Street & Ors v Retravisio & Ors* (1995) 16 ACSR 780 (FCA, Gummow J)

<sup>14</sup> Section 556 provided for each person with liability to be “jointly and severally liable for payment of the debt” under section 556(1). In addition section 556(4) provided that nothing in section 556(1) “affects any rights of a person to indemnity, subrogation or contribution”. The provisions are now found in Part 5.7B of the *Corporations Act*.

<sup>15</sup> Ibid at 215. As explained in *Street v Retravisio*, the right of contribution was implicit in and did not flow out of section 556 - per Gummow J at 784.

<sup>16</sup> See Meagher, Gummow and Lehane (supra note 2) at paragraphs 1017-1019.

It would further seem that the courts will recognise the right of the parties to contractually agree to vary the proportion of liability that they would otherwise bear.<sup>17</sup> For example, in the New Zealand case of *Trotter v Franklin*<sup>18</sup> the right of the parties to agree to contribute on an unequal basis was recognised. The court noted that if, having regard to the relationship of the parties, justice is better served by an award of unequal contribution instead of on a pro rata basis, the court may make such an order.<sup>19</sup>

### Contribution Among Joint Tortfeasors

The common law concerning tortfeasors who cause the same loss did not follow the path described above. Where a common law tort is involved, the traditional approach had been to deny actions of contribution brought by one tortfeasor against a joint tortfeasor. While the rule denying contribution among tortfeasors has a questionable basis in policy it would seem to remain the law in Australia.

The doctrine can be traced to the 1799 case of *Merryweather v Nixan*.<sup>20</sup> This rule is said to be based on the policy rationale that the court will not aid a person involved in an unlawful act.<sup>21</sup>

The common law rule denying tort contribution initially developed in relation to cases that involved the commission of criminal or intentional torts. However it has since been extended to other torts such as negligence.<sup>22</sup>

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<sup>17</sup> See for example in relation to co-sureties J. Phillips & J. O'Donovan "*The Modern Contract of Guarantee*" 2nd Edition, 1992, Law Book Company at 527; R. Goff & G. Jones "*The Law of Restitution*" 1966, Sweet & Maxwell at 177. For discussion see J. Lipton "*Equitable Rights of Contribution and Subrogation: Recent Australian Judicial Approaches*" (1995) 13 ABR 21 at 33-40.

In New South Wales it has been proposed that this be given statutory force - see Report 89 "*Contribution Between Persons Liable for the Same Damage*" (1999, NSW Law Reform Commission), Recommendation 3.

<sup>18</sup> *Trotter v Franklin* [1992] 2 NZLR 92 (NZ High Court).

<sup>19</sup> In that case a number of parties were tenants of a building and were guarantors of a loan to fund the building. Contribution in relation to the guarantees was awarded on the basis of the proportion in which outgoings in relation to the building had been shared rather than on a pro rata basis - see *Ibid* at 98.

<sup>20</sup> See *Merryweather v Nixan* (1799) 101 ER 1337; 8 TR 186. See also *Moxham v Grant* [1900] 1 QB 88. Earlier antecedents of the rule are *Battersey's Case* (1623) 124 ER 41; CP and the celebrated *Highwayman's Case of Everet v Williams* (1725) noted in this case law where the party seeking contribution from his companion for money obtained from robbery was not only denied contribution but both were hung!

<sup>21</sup> The maxim "ex turpi; causa non oritur actio" is frequently referred to.

<sup>22</sup> See *Dall v The Blue Wren Taxi Co Pty Ltd, Hickey & Ors* [1926] VLR 365 (two persons who by combined negligence cause injury are not entitled to contribution between each other).

Similar principles had developed in the United States - see the description in *Ruder* (1972) at 648-9.

An important qualification to the general rule is demonstrated by *Burrows v Rhodes & Jameson* [1899] 1 QB 816 where it was held that if a person is fraudulently induced to do an act that constitutes a tort or criminal offence without knowledge of the act's illegality, an action for indemnity in deceit or warranty can be brought against others involved - see at 828-9.

This common law rule can be strongly criticised from the policy perspective. For example the rule permits the plaintiff in an action to determine who should suffer the loss through its election to commence proceedings against any or all of the various people who have caused the loss.<sup>23</sup> In contemporary society this inevitably results in the persons with the deepest pockets bearing the loss. In the context of the *Corporations Act* it would seem fairly inevitable that the plaintiffs with insurers, such as accountants and lawyers, would bear the greatest risk.<sup>24</sup> As was noted above in relation to the doctrine of contribution, the unjust results that can arise from this situation were a key reason for the intervention of the courts of equity in developing the doctrine of contribution.

It should be noted that in other areas that are based on similar principles (for example the right to recover in negligence when two persons are involved in a criminal activity) there has been a judicial shift in Australia to a more enlightened approach.<sup>25</sup> However there has been no recent superior court reassessment of the appropriateness of the rule in *Merryweather v Nixan* in any Commonwealth country.

### Legislative Modification of Tort Rule

With a failure on the part of the courts to remedy the suspect policy underpinnings of the rule in *Merryweather v Nixan*, it has been left to the legislature to fashion an appropriate response. Each Australian state has developed a legislative modification to the rule. The difficulty is that the position varies significantly between each state.

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<sup>23</sup> Leading, in particular, to a crisis for auditors (and their insurers) in most jurisdictions around the world, particularly in Commonwealth jurisdictions with the conflict surrounding cases such as *Caparo Industries PLC v Dickman* [1990] 2 WLR 358.

<sup>24</sup> The rule against contribution has been supported as a mechanism to ensure loss is absorbed by the party best able to bear the cost: James “*Contribution Among Joint Tortfeasors: A Pragmatic Criticism*” (1941) 54 Harv L Rev 1156. In addition the rule has been supported by economists on the basis of efficiency by reducing administrative cost: Landes & Posner “*Joint and Multiple Tortfeasors: An Economic Analysis*” (1980) 9 J Leg Stud 517. On the other hand it has been argued such a rule promotes irresponsibility on the part of those without deep pockets: Gregory “*Contribution Among Joint Tortfeasors: A Defence*” (1981) 54 Harv L Rev 1170. See generally *Fleming* supra note 1 at 292-3.

<sup>25</sup> See *Jackson v Harrison* (1977-8) 138 CLR 438 (court will only deny right to claim in negligence when illegality results in court being unable to determine the standard of care expected, eg illegally detonating explosives).

For example, section 5 of the *Law Reform (Miscellaneous Provisions) Act* 1946 of New South Wales provides that contribution is available where damages are suffered as a result of a tort against any other person who would have concurrent liability.<sup>26</sup> The apportionment is based on a finding of what is “just and equitable”.

The Australian contribution statutes are based on the original English legislation.<sup>27</sup> The typical contribution statute itself is antiquated and gives rise to difficulties of interpretation.<sup>28</sup>

First, it is clear that the right to contribution under the New South Wales contribution statute requires a common law liability between the defendants in tort.<sup>29</sup> The difficulties in applying the statute to persons facing joint liability under Part 6D.3 of the *Corporations Act* are therefore obvious. That difficulty was graphically highlighted in the corporate law arena in the multiparty litigation in the *AWA Case*.<sup>30</sup> In that case claims of negligence were sustained against the auditor of AWA. However the auditor successfully established contributory negligence on the part of AWA through its senior management and claims of negligence on the part of its managing director and chairman. It had been argued in the case that contribution could not be sought by the auditors because their liability was contractual in nature. However, it was held the contribution statute can be relied on where there is concurrent liability both in tort and in contract.<sup>31</sup>

<sup>26</sup> “(1) Where damage is suffered by any person as a result of a tort (whether a crime or not) ...

(c) any tortfeasor liable in respect of that damage may recover contribution from any other tortfeasor who is, or would if sued have been, liable in respect of the same damage, whether as joint tortfeasor or otherwise, so, however, that no person shall be entitled to recover contribution from any person entitled to be indemnified by him in respect of the liability in respect of which the contribution is sought.

(2) In any proceedings for contribution under this section the amount of the contribution recoverable from any person shall be such as may be found by the Court to be just and equitable having regard to the extent of the person’s responsibility for the damage.”

<sup>27</sup> Section 6 of the *Law Reform (Married Women and Tortfeasors) Act* 1936. See now the *Civil Liability (Contribution) Act* 1978.

<sup>28</sup> In *Bitumen & Oil v Government Transport* (1955) 92 CLR 200 the comment was made that the legislation was “a piece of law reform which seems itself to call somewhat urgently for reform”.

See also the plea for law reform by Rogers CJ in *AWA Ltd v Daniels trading as Deloitte, Haskins & Sells and Others* (1992) 7 ACSR 759 at 877.

<sup>29</sup> See *McLaren v Fletcher* [1973] 2 NZLR 100 at 117; *Fleming* supra note 2 at 261.

<sup>30</sup> *AWA Ltd v Daniels trading as Deloitte Haskins & Sells and Others* (1992) 7 ACSR 759; 9 ACSR 383 (Supreme Court of NSW, Rogers J) and *Daniels & Ors (formerly practising as Deloitte, Haskins & Sells) v Anderson & Ors* (1995) 16 ACSR 607 (Court of Appeal).

<sup>31</sup> Ibid 7 ACSR at 856-7. In addition the same conclusion was reached in relation to contributory negligence - Ibid 7 ACSR at 856 declining to follow *Pacific Acceptance Corporation Ltd v Forsyth* (1970) 92 WN (NSW) 29 and *Simonius Vischer & Co v Holt* [1979] 2 NSWLR 322. In Victoria in *Lauren v Jolly* (unrep 8 April 1994) the Victorian Supreme Court, Appeal Division held a claim for contribution under the *Wrongs Act* must be concurrent liability between tortfeasors and it is not sufficient if the liability is an alternative liability. As such the position cannot be considered to be clear.

Similar issues arose for determination in *NRMA v Morgan*,<sup>32</sup> the only recent multiparty litigation involving claims of prospectus misstatement. The issue of contribution became a straightforward application of the *Law Reform (Miscellaneous Provisions) Act* because the claims of negligence in relation to legal advice given were sustained, but not the claims that would have established the basis for the contribution claim against NRMA under the *Misleading & Deceptive Conduct Provisions* of the *CL*.

To avoid the legal gymnastics demonstrated by the *AWA Case*, it has been recommended that the right to contribution be extended beyond tort to all forms of liability for the same damage.<sup>33</sup> The problem has been solved in Victoria where contribution is available:

“whatever the legal basis of liability, whether tort, breach of contract, breach of trust or otherwise.”<sup>34</sup>

Second, the New South Wales contribution statutes also require liability for “the same damage”. This means that a person seeking contribution must prove that liability exists on their part and also on the part of the person from whom contribution is sought. This rule would tend to deter settlements where there are doubts as to liability.<sup>35</sup> More modern legislation has removed the nexus of liability and extended the provision to bona fide settlements.<sup>36</sup>

The key point that comes out of the contribution statutes is that the court is afforded a broad discretion as to how it will apportion liability. The statutory formulation is based on what is “just and equitable”. This criteria provides a court with great latitude as to the proportionate

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<sup>32</sup> *NRMA Ltd & Ors v Morgan & Ors* (1999) 31 ACSR 435 (SCNSW, Giles J), on appeal *Heydon & Ors v NRMA Ltd & Ors* [2000] NSWCA 374;36 ACSR 462 (as the primary findings of Giles J were overturned on appeal the Court of Appeal did not consider the contribution issues in the appeal decisions). The case involved claims of breach of contract, negligence, contravention of the *Misleading & Deceptive Conduct Provisions* and *CL* section 996 by NRMA against its legal advisors in the failed demutualisation and initial public offering of NRMA for negligent legal advice (in relation to the application of the principles dealt with in the case of *WCP v Gambotto* to the transaction) and misleading statements in the prospectus. The claims of negligence for negligent legal advice succeeded but the claims of prospectus misstatement failed (despite having been successful in *Fraser v NRMA Holdings Ltd* (1994) 14 ACSR 656 and 15 ACSR 590 against NRMA). In the pleadings the legal advisors sought contribution from NRMA in the event that the advisors were found to be tortfeasors in relation to the misstatement liability claim on the basis the reference to “or otherwise” in section 5(1)(c) simply required coordinate liabilities on the part of NRMA within the meaning of *Albion Insurance* - see at 489-493.

<sup>33</sup> The distinction has been abolished in England in the *Civil Liability (Contribution) Act 1978* (Eng)

<sup>34</sup> Section 23A(1) of *Wrongs Act 1958* (Vic).

<sup>35</sup> A settlement will not preclude contribution providing liability is clear; *Stott v W Yorkshire Car Co* [1971] 2 QB 651. See generally *Fleming* supra note 1 at 261-2.

<sup>36</sup> See sections 23(B) and 24(2B) of *Wrongs Act 1958* (Vic).

New South Wales has slowly moved towards the adoption of similar measures during the 1990s - see Report 89 “*Contribution Between Persons Liable for the Same Damage*” (1999, NSW Law Reform Commission).

contribution awarded amongst wrongdoers. Again, the *AWA Case* provides a useful recent illustration in the corporate law context of the application of such criteria.<sup>37</sup>

The approach of the court was to apply concepts of culpability and responsibility for the loss:

“In comparing the parties’ respective responsibility for the loss which occurred the court considers the degree of departure from the standard of the reasonable man; *Pennington v Norris* (1956) 96 CLR 10 at 16. ... In making the comparison, it is necessary not only to take into account the respective degrees of culpability, or blameworthiness, but also the extent to which the respective actions of the parties causally contributed to the loss; *Podrebersek v Australian Iron and Steel Ltd* (1985) 59 ALR 529 at 532; *Barisic v Davenport* supra at 111, 121, 131, 140. In determining the appropriate apportionment both the position and activities of the plaintiff and the defendants should be compared. Further, it is relevant to consider to what extent the activities of each party posed a risk to the other. ... *Karamalis v Commissioner of South Australian Railways* (1977) 15 ALR 629.”<sup>38</sup>

Similarly in *NRMA v Morgan* considerations of levels of culpability and the relative importance of the acts in question were considered by Giles J to form the basis of determining the appropriate apportionment of liability.<sup>39</sup>

The principles referred to above need to be treated with caution in the prospectus misstatement liability context, particularly in relation to the relative positions and activities of the parties. As discussed in greater detail below, most information will be sourced from the issuer and management. Deterrence suggests that the focus of inquiry should be on whether participants in the capital raising process have met the standard required of them instead of focusing on the source of the misstatement. In other words, culpability should prevail over responsibility in the prospectus liability context.

The *AWA Case* also suggests an alternative basis for contribution under the *Corporations Act*. Section 1318 of the *Corporations Act* provides that in any civil proceedings against specified

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<sup>37</sup> 9 ACSR at 399 and 402. The final award was 80% liability for the auditor, 20% liability for AWA for contributory negligence and contribution by AWA’s managing director and chairman for 10% of the auditor’s 80% liability (reducing the auditors total liability to 72%). Pro rata contribution was not contemplated.

<sup>38</sup> 9 ACSR at 392.

<sup>39</sup> See 31 ACSR at 799-801. Reference was made to *Podrebersek v Australian Iron & Steel Pty Ltd* (1985) 59 ALR 529. The apportionment between the two solicitors to NRMA on the transaction and the barrister providing written advice was ultimately determined to be equal (one third each).

A further illustration in the securities context is *Australian Breeders Co-operative Society Ltd v Jones & Ors* (1997) 26 ACSR 26 (FCA, Wilcox, Lee & Lindgren JJ) at 83-6 (differential contribution between promoters and parties to an unregistered managed investment scheme).

persons a court may relieve the party of liability for negligence, breach of trust or breach of duty on such terms as it thinks fit.<sup>40</sup>

In the *AWA Case*, it was suggested that the section could be used to achieve the same objective as a defence of contributory negligence for the auditors of AWA:

“The section is appropriate to operate as provision for the proper allocation of fault .... The expression “having regard to all the circumstances of the case” in section 1318 is all embracing and is not clear to me what advantage the proper administration of the law will have from denying the full scope of its operation.”<sup>41</sup>

## 10.2 THE CORPORATIONS ACT PROVISIONS

### Corporations Act: Inadequate Coverage

The *Corporations Act* would seem to have been drafted without any regard to issues of joint liability. That failure gives rise to ambiguity and a possibility that a court may find that no doctrine of contribution will apply on the approach of *Merryweather v Nixan*.

As has been discussed, Part 6D.3 has an operation that is analogous to the standard of care that applies to the tort of negligence.<sup>42</sup> If that is the case the rule in *Merryweather v Nixan* would deny contribution. On the other hand, the contribution statutes may not apply (except in Victoria) because liability is not incurred through the law of tort.<sup>43</sup>

The position can be contrasted to that in the case of *Spika Trading Pty Limited v Harrison*.<sup>44</sup> There contribution was permitted in relation to joint and several liability for insolvent trading under the *Corporations Law*. It was argued in the case that insolvent trading constitutes an illegal act for which contribution should be denied. While the impact of illegality upon liability in negligence was noted by Giles J to be “a troublesome area ... where the law is still developing”<sup>45</sup> the argument was rejected. Giles J noted that deterrence would be best served by allowing

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<sup>40</sup> See the *AWA Case* 7 ACSR 759 at 855. The genesis of this provision was recommendations of the Reid committee of 1906. The provision was seen as a device to ensure that penal provisions of the securities laws were not used in a manner that operated unfairly. The original provision was section 372 of the *Companies Act* 1929 (England). The legislation was based on the *Judicial Trustees Act* 1896 (United Kingdom).

<sup>41</sup> 7 ACSR at 856.

<sup>42</sup> See Section 4.3.

<sup>43</sup> Unless, of course, a tort is also committed - see above. The difficulties of establishing liability in tort in the prospectus context are discussed in Section 5.3.

<sup>44</sup> *Supra* note 12.

<sup>45</sup> *Ibid* at 216 referring to *Jackson v Harrison* (1977-8) 138 CLR 438 noted at *supra* note 25.

contribution, as otherwise the defendant could elect to bring proceedings against only some of the directors or managers and, more importantly, because then section 558 specifically referred to contribution rights being preserved, suggesting a legislative intent that the doctrine was applicable.<sup>46</sup>

The key distinction between the insolvent trading provisions the subject of the *Spika* case and Part 6D.3 is that no reference is made to rights of contribution under Part 6D.3. On this basis a similar outcome to the *Spika* case cannot be presumed in analysing Part 6D.3.<sup>47</sup>

The fundamental proposition that flows from the above is that it would be desirable for the position of the doctrine of contribution to be clarified for purposes of Part 6D.3 liability. That clearly is not the case under the *Corporations Act*.

The only provision of the *Corporations Act* that potential bears on this question is section 1318, as noted above. Section 1318 vests the courts with general discretion concerning contraventions of the *Corporations Act*. Section 1318 gives the court a general power to give relief in civil proceedings relating to “negligence, default, breach of trust or breach of duty”. The court must be of the opinion that the person acted “honestly”.

The key deficiency of section 1318 as it may apply to capital raising is that it does not apply to persons other than officers, auditors and “experts”. For example, the underwriter is not specifically covered. Its application to advisors and others with liability under section 729 is ambiguous because of the lack of use of the term “expert” in the new Part 6D.3 and would depend on whether those persons can be considered an “expert”.<sup>48</sup>

Clearly a desirable reform approach might be to broaden section 1318 so that:

- it deals with each person who may have liability under Part 6D.3; and

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<sup>46</sup> Ibid at 217.

<sup>47</sup> It has been suggested that the *Spika* case itself no longer is applicable to the insolvent trading provisions - R. Lewis “*Contribution Between Directors: When a Company Cannot pay its Debts*” (1994) Law Society Jnl (NSW) May 1994 at 44.

Prior to June 1993 section 592 of the *Corporations Law* provided for “joint and several liability” among persons taking part in management for insolvent trading (s.592(1)) and recognised the potential application of contribution principles (s.594). The legislation was amended in June 1993 to insert section 588J which provides that any person contravening the insolvent trading prohibition (s.588G) must pay compensation. There is no specific reference to joint and several liability (although, as with Part 7.11, that is a logical consequence) or contribution. Lewis therefore questions if the new provisions give rise to “co-ordinate” liability within the meaning of *Albion Insurance Company Limited*.

<sup>48</sup> Previously the term “expert” was used in Part 7.11 but also in conjunction with other advisors. The term “expert” is defined in section 9 to be “a person whose profession or reputation gives authority to a statement made”.

- it specifically allows for a court to make contribution awards.

The desirability of giving the court power to modify the rigour of the prospectus liability rules in the manner contemplated by section 1318 has been noted in the United States literature where there is no comparable provision in the *Securities Act* 1933.<sup>49</sup> It has been argued that this provision would permit honest and reliable business people greater comfort that they will not be treated unfairly under the prospectus liability regime and reduce the risk of exploitative litigation by greenmailers.<sup>50</sup>

### Background to the Corporations Act

The failure of the *Corporations Act* to address issues of joint liability does not mean that the issue had not been recognised in prior legislation.

Consideration of the rule denying tort contribution was clearly part of the regulatory agenda in the formulation of the first prospectus misstatement legislation of the *1890 Directors Liability Act*. The legislation contemplated concurrent liability for directors and persons authorising a prospectus in a manner that was perceived to operate as a form of statutory tort.<sup>51</sup> The common law rule of *Merryweather v Nixan* denying contribution among joint tortfeasors was presumably determined to be inappropriate by the legislature in the prospectus context.

Section 5 of the *1890 Directors Liability Act* provided that persons liable for misstatements under that act by reason of being a director or person authorising the issue of the prospectus would be entitled to contribution from other persons with liability “as in cases of contract”.<sup>52</sup> That provision became part of Australian law<sup>53</sup> and subsisted until the uniform companies legislation of 1961. No reason was given at that time for its deletion.

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<sup>49</sup> See *Douglas & Bates (1933)* at 214-5 .

<sup>50</sup> These comments were made at that time in circumstances where there was public concern in the United States that section 11 imposed an overreaching regime of potential liability.

<sup>51</sup> See for example counsel’s argument in *Gerson v Simpson Reitlinger & Ors, Third Parties* (1902) 2 KB 197 at 198-200. This proposition is consistent with the observation that the *1890 Directors Liability Act* was a direct legislative response to the approach of *Derry v Peek* (1889) 14 AC 337 in relation to the tort of deceit.

<sup>52</sup> Section 5 provided:

“Every person who by reason of his being a director, or named as a director or as having agreed to become a director, or of his having authorized the issue of the prospectus or notice, has become liable to make any payment under the provisions of this Act, *shall be entitled to recover contribution, as in cases of contract, from any other person who, if sued separately, would have been liable to make the same payment.*” [emphasis added]

<sup>53</sup> In New South Wales in the *Companies Act* 1936.

In the intervening period the question of joint liability did not receive a great deal of judicial consideration. A very small body of English case law does exist in relation to these contribution provisions dating from the turn of the century.<sup>54</sup> The issues addressed by that case law are limited.

It is clear from the case law that, where a director or promoter was sued by an investor, and his fellow directors or promoters were not sued, rights of contribution could be claimed against those other persons<sup>55</sup> even where that person had since died.<sup>56</sup> Each defendant remained responsible for the payment of compensation payable to the plaintiff jointly and severally, despite the right to claim compensation.<sup>57</sup> The reference in the statute to contribution being determined “as in cases of contract” was considered to require the application of the same legal principles as are applicable in cases of contract where persons liable for the same debt have equitable rights of contribution.<sup>58</sup>

Each of the above conclusions seem correct from the policy perspective and are consistent with modern case law concerning equitable compensation.

The more interesting issue for consideration is the basis on which liability is shared if a claim of contribution is made out. The turn of the century case law on the *1890 Directors Liability Act* illustrates this point.

*Gerson v Simpson* involved a claim for prospectus misstatement under the *1890 Directors Liability Act* against a promoter of a company who was also its chairman. Claims of contribution were pursued by the director against a co-promoter and against two other directors.<sup>59</sup> The co-promoter was held to be liable for the prospectus misstatement under the legislation on the basis he knew the statement to be fraudulent. The two other directors were found not to have liability under the legislation.<sup>60</sup> As between the two persons held to have liability under the legislation for

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<sup>54</sup> *Gluckstein v Barnes (Official Receiver and Official Liquidator of Olympia, Limited)* [1900] AC 240; *Gerson v Simpson* supra; *Shepherd v Bray* [1906] 2 Ch 235; *Geipel v Peach* [1917] 2 Ch 108; *Walsh v Bardsley* (1931) 47 TLR 564.

<sup>55</sup> *Gerson v Simpson* supra at 200 (per Earl of Halsbury LC). In the promoter context see also *Boulter v Peplow* (1850) 9 CB 493; *Batard v Hawes* (1853) 2 E&B; *Edger v Knapp* (1843) 5 Man & Co 753; *Lefroy v Gore* (1844) 1 Jo & Lat 571.

<sup>56</sup> *Shepherd v Bray* involving a claim for contribution against the executors of directors who had died.

<sup>57</sup> *Gluckstein v Barnes* at 255 (Lord Macnaughten).

<sup>58</sup> See *Shepherd v Bray* at 253 (Warrington J).

<sup>59</sup> Supra at 198.

<sup>60</sup> It is not clear on what basis the two directors escaped liability. The report of the case does not refer to the defences of the *1890 Directors Liability Act* but instead refers to questions of whether the directors had knowledge of falsity of the misstatements - Ibid at 201-2. The case would therefore seem to be suspect in its reasoning on this point.

the misstatement the judge awarded contribution equal to 50% of the total compensation awarded to the plaintiff and the costs of the defence.<sup>61</sup> In *Shepherd v Bray*, the prima facie liability of co-directors to contribute equally for damages awarded under the *1890 Directors Liability Act* was again confirmed.<sup>62</sup>

The English precedent therefore seems to be authority for the award of pro rata contribution.

The *SIRC Report* was not oblivious to issues of joint liability. The need for some sort of resolution of this issue was addressed in dealing with the proposal to extend primary civil liability to the underwriter:

“The second proposed provision is a statutory right of indemnity against the persons primarily liable in respect of the prospectus (directors, promoters, etc). The extent of this right is limited only to the culpability of those persons - for example, if both the promoters and the underwriter are liable to the investor, then the underwriter may claim indemnity from the promoters.”<sup>63</sup>

Unfortunately the *SIRC Report* did not otherwise deal with the issue and therefore failed to pose the issue as one for general resolution in restating the prospectus laws.

The legislative history of the *Corporations Act*, both with the original *Corporations Bill* and the *CLERP Bill* does not demonstrate any recognition of the *SIRC Report* proposals or attempt to deal with joint liability issues generally. The *Simplification Task Force* did not consider the issue.<sup>64</sup>

### Comparison with Other Jurisdictions

Other than the case law described above, there is no English material of assistance to an assessment of joint liability issues. The *Financial Services and Markets Act 2000* and *The Public Offers of Securities Regulations 1995* no longer make provision for contribution. However, as discussed above, the general English contribution statute has been broadened to include statutory liability.

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<sup>61</sup> Ibid at 202. Affirmed by Court of Appeal. Ibid at 204.

<sup>62</sup> Ibid at 254. There were 14 directors, 2 of whom were insolvent, resulting in pro rata liability among the remaining 12.

Appeal costs and costs associated with settling proceedings were not considered to be amounts capable of an award of contribution within the statutory regime (Ibid at 254).

<sup>63</sup> *SIRC Report* at paragraph 6.4.

Section 11 of the *Securities Act* deals specifically with the consequences of joint liability under that legislation. The model was section 5 of the *1890 Directors Liability Act*, as it was then part of English law.<sup>65</sup> Section 11(f) copies its English source and provides for a right of contribution for any person with liability under section 11 to be liable for contribution “as in cases of contract” unless the person seeking contribution is guilty of fraudulent misrepresentation.<sup>66</sup> The legislative purpose of section 11(f) was also to reverse the common law rule in the United States denying tort contribution.<sup>67</sup>

From 1995 section 11 of the *Securities Act* was amended to provide that non-executive directors only have proportional liability imposed on them, in the absence of knowledge of the misstatement.<sup>68</sup>

There is very little United States jurisprudence on section 11(f), although what case law does exist demonstrates a greater degree of judicial flexibility than that applied by the English courts.

In *Globus v Law Research Service*<sup>69</sup> an underwriter had paid damages under the securities laws.<sup>70</sup> Pro rata contribution was awarded to the underwriter between the issuer, the underwriter and one of its officers. While rejecting the enforceability of a contractual indemnification clause (see

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<sup>64</sup> This author raised the issue with members of the *Simplification Task Force* at the time and was advised that they considered issues of contribution to be outside their mandate.

<sup>65</sup> The precise model was section 37(3) of the *Companies Act 1929* (England) - see *Douglas & Bates (1933)* at 178; *Ruder (1972)* at 650; *Dooley (1972)* at 793; *Scott (1986)* at 235; *Loss & Seligman (1995)* at 1150.

<sup>66</sup> Section 11(f) provides as follows:

“All or any one or more of the persons specified in subsection (a) shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.”

The last phrase denying contribution for fraudulent misrepresentation was included in section 37(3) of the *Companies Act 1929* but not the *1890 Directors Liability Act*.

<sup>67</sup> The principle of *Merryweather v Nixan* had been adopted by the United States courts, although by the early 20th century the inequity of the rule had led to it being discarded in many United States jurisdictions and replaced by a principle of “tort-indemnity” rule of proportional liability based on degrees of negligence - see *Ruder (1972)* at 648-9; *Scott (1986)* at 248-9.

<sup>68</sup> Section 11(f)(2) and Section 21D(f) of the *Securities Exchange Act 1934*. For discussion see M. I. Steinberg & C. D. Olive “*The Private Securities Litigation Reform Act: Contribution and Proportionate Liability*” (1997) 24 Sec Reg LJ 333; D. C. Langevoort “*The Reform of Joint and Several Liability Under the Private Securities Litigation Reform Act of 1995 - Proportionate Liability, Contribution Rights and Settlement Effects*” (1996) 51 Bus Law 1157.

<sup>69</sup> *Globus et al v Law Research Service, Inc et al* 318 F Supp 955 (SDNY 1970) affd 442 F 2d 1346 (2d Cir 1971) cert denied 404 US 941 (1971).

<sup>70</sup> The underwriter was held liable under section 12(2) of the *Securities Act* and section 10(b) of the *Securities Exchange Act 1934* which do not provide for contribution. The court implied a right of contribution in these circumstances in the same terms as section 11(f) on the basis that denying contribution would “dilute the deterrent impact of the securities laws” (Ibid at 958) by leaving the entire burden on one party rather than requiring liability for all who failed to satisfy the statutory standard. This position was confirmed by the Supreme Court in relation to Rule 10b-5 in *Musick, Peeler & Garrett v Employers Institute of Wausau* 113 S Ct 2085 (1993) with similar reasoning. See also *Laventhol, Krekstein, Horwath & Horwath v Horwath* 637 F 2d 672 (9th Cir, 1980) cert denied 452 US 963.

analysis below), the court considered that the policy of the securities laws was advanced through applying principles of contribution because the spreading of liability would ensure that all persons involved in the capital raising process are encouraged to take proper care.<sup>71</sup> Clearly that fundamental starting point has lessons for an appropriate response in the Australian context.

Contribution was again awarded in the *Feit Case*.<sup>72</sup> In that case each of three directors were held liable for \$5,000 while the issuer was left to pay the balance of the damages awarded, exceeding \$300,000. There was little analysis of the reasons for the basis of this allocation.

On the other hand, in *Gould v American-Hawaiian Steamship Company*<sup>73</sup> competing rationales for contribution were given greater attention. The case involved allegations of proxy misstatement made against a number of defendants comprising two companies, directors of each company and various shareholders. A number of parties settled. In the subsequent proceedings liability was established against the non-settling parties who then sought contribution from the parties that had settled.

The non-settling parties had argued that the term “as in cases of contract” in section 11(f) meant that contribution must be pro rata. That argument was rejected by the court on the basis that the intent of section 11(f) was not to require pro rata contribution but instead intended to overturn the common law rule denying contribution among joint tortfeasors. The court considered that equitable principles should determine the basis of contribution.<sup>74</sup>

Having rejected pro rata contribution, an alternative argument that contribution should be based on the “benefits received” by each defendant from the transaction was similarly rejected. One of the companies involved received no benefits from the transaction and argued that it should receive contribution equal to its total liability from those who had received benefits. This argument was rejected by the court on the basis that a “benefits received” approach would circumvent a legislative policy of deterrence by permitting those whose misconduct had

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<sup>71</sup> Ibid at 958.

<sup>72</sup> *Feit v Leasco Data Processing Equipment Corp* 332 F Supp 544 (EDNY 1971).

<sup>73</sup> *Gould v American Hawaiian Steamship Company* 387 F Supp 163 (D Del 1974) vac on other grounds 535 F 2d 761 (2d Cir).

<sup>74</sup> The United States common law rule concerning contribution had typically applied a pro rata approach - Ibid at 170. It has been argued that the genesis of section 11(f) and the reference to the words “as in cases of contract” requires the court to award pro rata contribution - see *Ruder (1972)* at 650-1 (citing *Douglas & Bates (1933)* at 178); *Loss & Seligman (1995)* at 1150. The alternative view is that the words merely negate the rule in *Merryweather v Nixon*.

The balance of recent authority is to favour the *Gould* approach - see for example *Smith v Mulvaney* 827 F 2d 558 (9th Cir 1987); Note “*Apportioning Contribution in Section 10(b) and Rule 10b - 5 Multi-Defendant Suits: A Critique of Relative Culpability Shares in the Wake of Smith v Mulvaney*” (1988) BYUL Rev 409.

empowered the breach, but had received little financial reward, would effectively be indemnified.<sup>75</sup> A further argument that contribution should be based on the comparative fault of each of the parties was not applied by the court. The court did not consider that the facts demonstrated any significant differences in culpability among the parties.

The court instead made an award of contribution based on an equitable determination. The decision therefore illustrates a case by case approach to awarding contribution based on the promotion of the regulatory purposes of the statute.<sup>76</sup>

A similar approach is reflected by *McLean v Alexander*<sup>77</sup> where a number of defendants were grouped into two categories for purposes of awarding contribution, based on fault. As between the two categories of defendant, liability was apportioned on a 90/10 basis. Within each category of defendant, liability was shared on a pro rata basis. The case therefore reflects an amalgam of pro rata and relative fault rationales of contribution.

There is academic debate in the United States as to the merits of the various approaches illustrated by the case law referred to above.

Some academics support a simple pro rata rule of contribution in that it has advantages of simplicity and ease of administration.<sup>78</sup> In applying more complex contribution rules not only must a court make findings on the liability of the defendants to investors, the court must also assess the position between the various defendants, which may have little to do with the interests of investors. As such, securities cases can be expected to be lengthier and more complex.

In addition, a pro rata rule may encourage settlement.<sup>79</sup> Unequal contribution complicates not only trials but also settlements because even if a party settles that does not prevent a later contribution proceeding re-opening the issue of comparative liability, as demonstrated by the

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<sup>75</sup> As such, the court held a “benefits received” formulation would be limited by policies against full indemnification - Ibid at 170. As to indemnification see analysis below.

<sup>76</sup> See also *Note (1977)* at 96; *Scott (1986)* at 235.

<sup>77</sup> *McLean v Alexander* 449 F Supp 1251 (D Del, 1978) rev 599 F 2d 1190 (3d Cir).

<sup>78</sup> See *Douglas & Bates (1933)* at 179-81; *Note (1977)* at 97; *Scott (1986)* at 255.

<sup>79</sup> See *Note (1977)* at 97.

*Gould* case.<sup>80</sup> Therefore, it can be argued that unequal contribution involves far greater administrative costs than pro rata contribution.<sup>81</sup>

The primary perceived defect of pro rata contribution is that it can be argued to give rise to inequitable results in that the approach fails to distinguish between more responsible parties from those with little culpability.<sup>82</sup> This argument is most pronounced in situations where a spectrum of wrongful conduct - fraud, recklessness, negligence and innocent error - may give rise to potential liability on the same facts.

For that reason it is likely that permitting unequal contribution based on relative fault criteria will be more useful in furthering legislative objectives of deterrence. If principles of comparative fault are considered, more culpable parties will have greater risk and therefore will be more strongly deterred.<sup>83</sup>

However, concern has been expressed in relation to relative fault contribution theories that such an approach should not result in a focus on responsibility for a prospectus misstatement over legal fault for that misstatement.<sup>84</sup> For example, it will normally be the case that an issuer and its officers will have the greatest responsibility for a prospectus misstatement in that they will have the closest connection to the circumstances that could have avoided the loss occurring. On the other hand if the underwriter also fails in its enquiry functions to identify the problem that should not mean that the issuer and its officers should have a disproportionately greater responsibility than the underwriter for the loss.<sup>85</sup> It has been argued the approach of the court should be to consider the relative responsibilities of the various persons within the statutory scheme of the liability provisions and then apply contribution on the basis of deviance from accepted norms for that type of person, rather than relative culpability as amongst the different participants.<sup>86</sup>

As has been noted above, a third possible theory of contribution - benefit disgorgement - has been noted but was rejected as appropriate in the *Gould case*. Such an approach receives little support

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<sup>80</sup> For analysis and judicial approaches to facilitating settlement in these circumstances see *Hickman (1992)* at 654 - 6 (subsequent orders based on percentage of fault rather than dollar settlement amount).

<sup>81</sup> See *Note (1977)* at 97-8.

<sup>82</sup> See *Scott (1986)* at 256; *Hickman (1992)* at 660 - 2.

<sup>83</sup> See *Note (1977)* at 100.

<sup>84</sup> See *Scott (1986)* at 260; *Note (1977)* at 100.

<sup>85</sup> See *Scott (1986)* at 257,260.

<sup>86</sup> See *Scott (1986)* at 260; *Note (1977)* at 99-100; Note (M.J. Suarez) *A Comparative Fault Approach to the Due Diligence Requirement of Rule 10b-5*" (1981) *Fordham L Rev* 561 at 582-3 and 588.

in the academic material.<sup>87</sup> Clearly that rejection is appropriate as deterrence is hardly served by recognising that the most a professional will risk is the loss of its fee.<sup>88</sup>

The advantages and disadvantages of a pro rata rule and a comparative fault rule are therefore easily summarised. The pro rata rule has the advantage of simplicity while the relevant fault rule has advantages of greater fairness. As the United States case law demonstrates, the optimum resolution of this issue is for the courts to retain flexibility, having regard to the policy issues underpinning the area, and to apply an amalgam of the two principles to ensure justice is dispensed in a cost effective manner while ensuring principles of fairness and deterrence are maintained.<sup>89</sup> That approach is demonstrated by the *Gould case* described above. The approach has been followed in other United States securities law cases.<sup>90</sup>

The above analysis illustrates that the approach of the United States courts in this area is much more sophisticated than is demonstrated by the limited amount of English material surveyed above. It can be argued by reference to this material that when contribution principles come to be applied to a multi-party action under Part 6D.3, the appropriateness of a pro rata theory of

<sup>87</sup> See *Note (1977)* at 98-9. The *Note (1977)* suggests benefits received may be a better starting point of analysis than pro rata contribution, with further adjustment then based on appropriate deterrence (see at 101).

<sup>88</sup> In addition, where the issuer is insolvent, contribution on this basis may result in the advisors competing against injured investors for the assets of the issuer, reducing the return of those investors - see *Scott (1986)* at 261.

<sup>89</sup> See *Note (1977)* at 96,99. The *Note (1977)* (at 102-3) provides an illustrative analysis as to how that liability might be apportioned within an underwriting syndicate.

“Pro rata contribution would simplify the process of allocating liability but would make the deterrent irrational and haphazard. Some deviation from a pro rata scheme is essential. Benefits received, comparative fault, financial capacity, and the need to preserve deterrence will provide sensible, general guidelines for parties contemplating settlement and for courts compelled to participate in the allocation process.”

(*Note (1977)* at 104.)

<sup>90</sup> See *Wassel v Eglowsky* 399 F Supp 1330 (D Md, 1975) affd 542 F2d 1235 (4th Cir, 1976); *Smith v Mulvaney* [1984-5 Transfer Binder] Fed Sec L Rep (CCH) 92,084 (SD Cal) affd 827 F 2d 558 (9th Cir, 1987). Such an approach has been described as an “entity theory” - see *Scott (1986)* at 262-4.

The ALI Federal Securities Code proposed similar guidelines for contribution that are of some assistance (section 1724(f)):

“To the extent consistent with section 1724(e) -

(1) ... ; and

(2) to the extent that there is no such contract, and on consideration of the relative responsibility of each person for the loss incurred, the judgment in an action for contribution may -

(A) order any such person to pay to any other such person as much as is determined to be just and equitable by way of contribution;

(B) order that the contribution of any such person amount to a complete indemnity; or

(C) determine that any such person is not liable to make contribution,

except that no such person may be ordered to pay more under section 1724(f) than what his maximum liability would have been if he had been a defendant in the action giving rise to the action for contribution.”

contribution would be open to question. Clearly unfairness would arise if a deceitful director were required to share loss to the same extent, for example, as a negligent banker.

The *Private Securities Litigation Reform Act 1995* has had a significant impact on the US securities law structure by introducing proportional liability, rather than joint and several liability, for some securities law claims. Under these provisions, for claims based on the *Securities Exchange Act 1934*,<sup>91</sup> a defendant will only be liable in an amount proportional to its respective responsibility for the loss, unless there is a finding that the defendant acted deliberately. This regime is not applicable to section 11 or section 12(2) liability (except for the non-executive director in a section 11 proceeding)<sup>92</sup> but is illustrative of the attempts being undertaken in the United States to reduce the scale of speculative securities litigation.

### Comparison of Corporations Act to the Trade Practices Act Position

It is interesting to contrast the position under the *Corporations Law* with the position under the *Trade Practices Act*. It is no surprise that section 82 of the *Trade Practices Act*, the model for the damages remedy in section 729 of the *Corporations Act* (and before it section 1005) fails to deal with joint liability issues.

The failure of the *Trade Practices Act*<sup>93</sup> to deal with issues of joint liability among persons facing potential civil liability for the same loss has been criticised from the policy aspect.<sup>94</sup> It is interesting that despite the large body of jurisprudence concerning liability under section 52 of the *Trade Practices Act* that has developed over the last 20 years, the law relating to joint liability under that legislation remains largely undeveloped.

It can be argued that the need for the *Trade Practices Act* to deal with issues of joint liability is less pressing than in Part 6D.3 of the *Corporations Act*. Part 6D.3 of the *Corporations Act* specifically contemplates a multitude of parties will have primary liability for a prospectus

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<sup>91</sup> Section 21D(f)(2).

<sup>92</sup> Section 11 (f)(2).

<sup>93</sup> The position under each state's *Fair Trading Act* is identical to the *Trade Practices Act*. For example the *Re: La Rosa case* infra note 96 also involved proceedings under the *Fair Trading Act 1987* (Western Australia). For convenience references in this section will refer only to the *Trade Practices Act*.

<sup>94</sup> See *Campbell (1993)* at 90 and 186-7 and the discussion in JD Heydon "Damages under the *Trade Practices Act*" in Chapter 3 of "Essays in Tort" Finn (editor), 1989 at 52 - 4. See also the recommendation of the Australian Law Reform Commission "Compliance with the *Trade Practices Act 1974*" (Report No. 68, AGPS) at para 7.22-7.23.

In N. Seddon "Misleading Conducts: The Case for Proportionality" (1997) 71 ALJ 146 it is argued that the language of the *Trade Practices Act* permits the awarding of contribution on a proportional basis through principles of causation (at 152). However, there is no support for that view in recent case law.

misstatement, subject to the establishment of the due diligence defences that are applicable to them. On the other hand, section 52 of the Trade Practices Act by its terms contemplates a single corporation engaging in proscribed conduct. However, the *Trade Practices Act* clearly cast a wider net than a single entity facing liability and joint liability issues are inevitable.<sup>95</sup>

In the 1991 case of *Re La Rosa*<sup>96</sup>, a claim for damages under section 82 of the *Trade Practices Act* was brought against a corporation and one of its directors. Those parties cross-claimed against third parties who it was alleged had also committed misleading and deceptive acts, effectively seeking contribution.<sup>97</sup>

French J considered that there is no mechanism in the *Trade Practices Act* to enable the court to make orders for contribution or indemnity against other contraveners of the *Trade Practices Act* or person “involved” in a contravention of the legislation.<sup>98</sup> In view of the largely identical

<sup>95</sup> For example, a person “involved” in a contravention of section 52 under section 75B of the *Trade Practices Act* will also face civil liability under section 82 of that act for the conduct engaged in by the corporation. In addition, as with tort law generally, it is frequently the case that more than one person will be involved in an enterprise that causes loss and each of those persons may have engaged in conduct within the meaning of the legislation. Alternatively a number of people will separately engage in proscribed conduct resulting in the same loss to a third party.

See *Fleming* supra note 1 at Chapter 11, pages 288-90. It has been found that such persons will be concurrently liable for the loss caused by the breach: *Tomlinson v Cut Price Deli Pty Limited* (1995) ATPR 46-151 at 53,181 (FCA, Drummond J).

<sup>96</sup> *Re: La Rosa and Anor; Norgard v Rodpat Nominees Pty Ltd and Anor* (1991) ATPR 41-139 (FCA, French J). The case involved cross claims in insolvency proceedings alleging misleading and deceptive conduct in connection with transactions alleged to constitute voidable dispositions under the Bankruptcy Act.

<sup>97</sup> The first ground given for the right to bring the cross-claim was that section 87(1A) and section 87(2)(d) of the Trade Practices Act permitted an award of indemnity or contribution among persons with joint liability. The alternative basis given for the cross-claim was based on equitable doctrines of contribution. For Part 6D.3 liability under the *Corporations Act*, section 87(1A) finds its counterpart in section 1325(2) of the *Corporations Law* and section 87(2)(d) finds its counterpart in section 1325(5)(e). The sections provide as follows:

“1325(2) The Court may, on the application of a person who has suffered, or is likely to suffer, loss or damage because of conduct of another person that was engaged in contravention, ... make such order or orders as the Court thinks appropriate against the person who engaged in the conduct or a person who was involved in the contravention (including all or any of the orders mentioned in subsection (5)) if the Court considers that the order or orders concerned will compensate the person who made the application, or the person or any of the persons on whose behalf the application was made, in whole or in part for the loss or damage, or will prevent or reduce the loss or damage suffered, or likely to be suffered, by such a person.”

“1325(5) The orders referred to in subsections (1) and (2) are:

(e) an order directing the person who engaged in the conduct or a person who has involved in the contravention constituted by the conduct to pay to the person who suffered the loss or damage the amount of the loss or damage;”

The cross claim based on section 87(1A) was struck out as a matter of statutory interpretation of the relevant provisions on the basis that the Trade Practices Act contemplates that an applicant for relief under section 87(1A) is not a person who has himself contravened section 52. Section 87(1A) contemplates compensation to a person who suffers “loss or damage” by conduct of another person and before the order is made it will “compensate” the person from the loss or damage. *Re: La Rosa* at 52,99.

<sup>98</sup> *Re: La Rosa* at 52,999. Similarly in *Australia and New Zealand Banking Group Limited v Turnbull & Partners Limited & Ors* (1991) 33 FCR 265 (FCA, Sheppard J) it was held that a right of contribution is not conferred by the remedy in section 87 of the Trade Practices Act (at 276). To similar effect see *Bialkower v Acohs Pty Ltd* (1999) ATPR 41 - 685 (FCA, Beaumont, Hill & Sundberg LJ).

See also *Lezam Pty Limited v Seabridge Australia Pty Limited* (1992) 35 FCR 35; *Gentry Bros Pty Limited v Wilson Brown & Associates Pty Limited* (1996) ATPR 41-460 at 41,615 (FCA, Kiefel J).

provisions in the *Corporations Act* a direct analogy can be drawn to the possible position under Part 6D.3.

The analysis of French J in the *Re La Rosa* case on this point can be criticised for its heavily legalistic approach to the wording of section 87(1A) in circumstances where there is a strong policy justification for the judicial recognition of apportionment of liability.<sup>99</sup>

In addition, the facts of the case were limited to the filing of cross claims, with specific argument that the legislation contemplated contribution or indemnity. It is open for a defendant who faces concurrent liability with a third party to commence proceedings against that party based on loss under section 82, arguing that any award of damages would result in the defendant having suffered loss caused by the misleading and deceptive conduct of the third party.<sup>100</sup> The *Re La Rosa* case did not involve claims of possible loss against the third party formulated in this way.

The difficulty with the alternative argument based on section 82 loss is that, if the claim for compensation against the third party is successful, the defendant would recover its total loss from the third party rather than some proportion of that loss.<sup>101</sup> This analysis will give rise to circular claims where the third party has also brought a similar claim against the defendant.

This conundrum and the criticism of French J's analytical approach to the relevant provisions of the legislation itself is partially assisted through the analysis of equitable contribution in the *Re La Rosa* case. The possibility of contribution being awarded on that basis between the parties was not struck out.<sup>102</sup> If such a claim were successful, it would not permit a claim of complete indemnity but instead result in equal or ratable relief.

The approach of *Re La Rosa* has been subsequently followed in other cases.<sup>103</sup> In each of these cases there has been little analysis of the common law rule denying contribution among joint tortfeasors. In *Re La Rosa* French J noted that it was open to argument that public policy might operate to deny contribution but that the issue should be best left to argument in the context of an

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<sup>99</sup> Contrast the judicial approach in the *AWA Case* above. See also the analysis of *Seddon* Supra.

<sup>100</sup> To the same effect see *Campbell (1993)* at 90.

<sup>101</sup> *Ibid.* This analysis assumes an award of compensation will be available upon application of general principles of reliance and causation applicable to section 82. In some situations proof may be difficult in the circumstances posed here. See *Campbell (1993)* at 98.

<sup>102</sup> *Re: La Rosa* at 52,999-53,001.

<sup>103</sup> *Trade Practices Commissioner v Manfal (No. 3)* (1991) 33 FCR 382 (FCA, Lee J); *Acohs Pty Limited v R.A. Bashford Consulting Pty Limited* (1997) 144 ALR 528 (FCA, Merkel J). See also comments in *Dorrough v Bank of Melbourne Limited* (1995) ATPR 46-152 (FCA, Cooper J) and *Austotel Management Pty Limited v Jamieson* (1996) ATPR 41-454 (FCA, Burchett J).

assessment of all the evidence.<sup>104</sup> It is important to appreciate that each of these cases involved procedural issues rather than a final determination of the merits of the dispute. In view of the uncertainty that surrounds the application of the common law rule denying contribution, the approach of these cases in the context of misstatement liability involves serious ambiguities.<sup>105</sup>

In the context of the *Trade Practices Act* it has been argued by Campbell that section 52 of the *Trade Practices Act* constitutes a statutory tort so that tort liability will be considered to have arisen within the meaning of section 5 of the *Law Reform (Miscellaneous Provisions) Act* 1946.<sup>106</sup> The same arguments can be made by analogy under Part 6D.3 of the *Corporations Act*.

However, for both the *Trade Practices Act* and the *Corporations Act*, policy considerations would suggest the desirability of clarity on this important issue.<sup>107</sup>

### Conclusions on Corporations Act Position

The issue of joint and several liability became a law reform issue in Australia in the 1990s as a result of claims brought against professional advisors (particularly accountants) arising from the excesses of the 1980s. The key issue on the law reform agenda in the 1990s is whether it would be appropriate to move to a regime of proportional liability instead of providing for joint and

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<sup>104</sup> Ibid at 53,0001. To similar effect see also *Trade Practices Commission v Manfal* at 40,182.

<sup>105</sup> To similar effect see *Campbell (1993)* at 91.

<sup>106</sup> See *Campbell (1993)* at 93 and analysis at 108. Of course that analysis will be less significant in jurisdictions such as Victoria.

This approach received some support in *Dorough v Bank of Melbourne Ltd* (1995) ATPR 46-152 at 53,185 (FCA, Cooper J).

However, a claim for contribution on this basis was struck out in *ANZ Banking Group Ltd v Turnball & Partners Ltd* (1991) 33 FCR 265 (FCA, Sheppard J). The ANZ approach received support in *Bialkower v Acohs Pty Ltd* (1999) ATPR 41 - 685 (FCA, Beaumont, Hill & Sundberg LJ).

There are also constitutional uncertainties as to whether the state based contribution statutes can apply to the Commonwealth Trade Practices Act - see *State of Western Australia v Bond Corporation Holdings Pty Limited* 14 June 1992 unreported (FCA, French J) and *Pricom Pty Limited v Sgairoto* (1994) ATPR 41-365 at 42,755 (Vic SC, Eames J). That will also be the case with the *Corporations Act*.

<sup>107</sup> The above line of case law has arguably been thrown into doubt by the 2001 High Court decision in *Henville v Walker* [2001] HCA 52 where it was held that contributory negligence could not be used to reduce damages awarded under section 82 of the Trade Practices Act. The majority view reflects an ongoing unwillingness on the part of the High Court to apportioning responsibility for loss in awarding damages.

several liability with rights of contribution.<sup>108</sup> This debate involves significant policy issues that require consideration.<sup>109</sup> The debate has not resulted in law reform.

One of the key criticisms of proportionate liability is that a plaintiff runs a greater risk under such a system of not being compensated for loss that has been suffered. In situations such as personal injury, the policy reasons for opting for joint and several liability are clearer as compensation is obviously the key consideration in this situation. In the securities law context, particularly where deterrence is a significant objective of the legislative scheme, this is a less pressing policy concern. As such, it can be argued that the policy reasons in favour of proportional liability over joint and several liability are greater in the context of prospectus liability.

While the joint and several/proportional liability debate is of general interest, there is a much more pressing need in the prospectus context for a basic framework to be established. The structure of the civil liability provisions are clearly deficient in their failure to provide explicitly for contribution to remove the ambiguities that currently exist. In view of the federal nature of the *Corporations Act* jurisdiction, it is appropriate that contribution be dealt with explicitly in the *Corporations Act* so that state by state anomalies do not exist as is currently the case.

Clearly there are a number of possible mechanisms by which that outcome could be achieved. Perhaps the simplest method would be to broaden the scope of Section 1318 in the manner suggested above so that the allocation mechanism is available to all provisions of the *Corporations Act* involving concurrent liability. The alternative would be a specific mechanism in Part 6D.3 along the lines of the United States model.

Once an effective right to contribution is established, the issue that then arises is the basis on which contribution should be provided. The United States cases clearly demonstrate the desirability of moving to a form of contribution mechanism that is based on relative fault, with sufficient flexibility to ensure justice is dispensed in a cost effective manner while ensuring principles of fairness and deterrence are maintained.

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<sup>108</sup> See “*Inquiry Into the Law of Joint and Several Liability - Report of Stage One*”, 1994 (Commonwealth of Australia, 1994) and “*Inquiry into the Law of Joint and Several Liability - Report of Stage Two*”, 1995 (Commonwealth of Australia, 1995) (jointly commissioned by the Attorney-Generals for the Commonwealth and New South Wales on 17 February 1994) (known as the Davis Report) and New South Wales Law Reform Commission “*Contribution Among Wrongdoers: Interim Report on Solidary Liability*” (Report 65) (1990).

<sup>109</sup> For analysis see for example Mednick & Peck “*Proportionality: A Much Needed Solution to the Accountant’s Legal Liability Crisis*” (1994) 28 Valparaiso L Rev 867 (argues for proportionate liability) and compare Wright “*The Logic and Fairness of Joint and Several Liability*” (1992) 23 Memphis State Uni L Rev 45 (supports joint and several liability).

### 10.3 CONTRACTUAL RISK SHIFTING DEVICES

If the issue of joint liability at general law is ambiguous, the obvious solution for a participant involved in the capital raising process is to establish a private arrangement to deal with the issue.

The ways in which this could be done are:

- a contractual indemnity arrangement where a participant involved in prospectus preparation seeks to be held harmless from any liability by another person (hopefully with deep pockets); or
- a contractual contribution arrangement where parties agree to share liability.

At the outset it is helpful to attempt to distinguish in definitional terms a contractual indemnity from a contractual contribution provision. Indemnification contemplates the total shifting of risk from one party to another. On the other hand, contribution contemplates a sharing of loss between two parties having joint liability.<sup>110</sup>

The contractual risk shifting device that has traditionally been employed is an indemnity contained in the underwriting agreement between the issuer and the underwriter. It is only recently that contractual contribution arrangements have become a feature of Australian securities practice.

#### Indemnity Clauses

The indemnity customarily taken by an underwriter in Australian securities offerings has the following features:

- the underwriter is indemnified and held harmless from any liability arising from the issue of the prospectus;
- the underwriter will be indemnified for loss arising as a consequence of breach of contractual warranty by the issuer. The issuer will warrant, among other things, that the prospectus complies with the *Corporations Act*;
- the indemnity will not extend to matters where the underwriter has acted fraudulently or with negligence (in many cases “gross negligence”).

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<sup>110</sup> See *Ruder (1972)* at 647; *Scott (1986)* at 225

The enforcement of a contractual indemnity for prospectus liability has not been considered by an Australian or English court. However, there is a body of analogous case law that provides useful guidance as to the likely approach of Australian courts when these provisions are ultimately tested.

As a starting point for analysis it is helpful to contrast the United States position. The leading United States decision on contractual indemnification is *Globus v Law Research Service, Inc*<sup>111</sup>, where it was held that an indemnification agreement between an underwriter and the issuer would not be enforced by the court as a matter of public policy where the underwriter had actual knowledge of a misstatement in a prospectus. The court reviewed relevant policy issues and determined that it would be against public policy to allow an underwriter to shift the risk of liability to an issuer in circumstances where the underwriter had actual knowledge of the misstatement:

“It is well established that one cannot insure himself against his own reckless, wilful or criminal misconduct ... [indemnity] would encourage flouting the policy of the common law and the *Securities Act*.”<sup>112</sup>

The deterrence basis of the civil liability provisions of the *Securities Act* was considered to impose a high standard of trusteeship on an underwriter that would be undermined if risk could be shifted by the underwriter to the issuer through an indemnity agreement.

A further ground for denying relief in the *Globus* case was the view expressed that to pass the loss purely on to the issuer would result in the loss ultimately coming out of the pockets of investors, it being noted that many of whom would be the “very purchasers to whom the underwriter should have been initially liable”.<sup>113</sup>

*Globus v Law Research Service, Inc* has been followed in subsequent cases.<sup>114</sup> In addition, the original actual knowledge requirement of the *Globus* case has gradually been expanded. In

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<sup>111</sup> *Globus v Law Research Service, Inc* 287 F Supp 188 (SDNY 1968), aff'd 418 F 2d 1276 (2d Cir, 1969), cert denied 397 US 913 (1970). The issuer, the president of the issuer and the underwriter were found to have violated section 17(a) of the *Securities Act* 1933. The case related to an offering of common stock by a research service company. The disclosure document failed to disclose a dispute with an important supplier. The underwriter cross-claimed against the issuer to enforce a contractual indemnity in the underwriting agreement.

<sup>112</sup> 418 F 2d 1276 at 1288-9.

<sup>113</sup> *Ibid* at 1289. The contrary argument is that there is a risk the issuer is unjustly enriched through retraining tainted proceeds in excess of its share of the loss - see *Note (1977)* at 91.

<sup>114</sup> See *Tucker v Arthur Andersen & Co* [1973-4 Transfer Binder] Fed Sec L Rep (CCH) 94,544; *Alexander & Baldwin, Inc v Peat, Marwick, Mitchell & Co* 385 F Supp 230 (SDNY 1974); *Gould v American-Hawaiian Steamship Co* 387 F Supp 163 (D.Del 1974) vac (other grounds) 535 F 2d 761 (3rd Cir 1976); *Odette v Shearson, Hammill & Co* 394 F Supp 946 (SDNY 1975); *Heizer Corp v Ross* 601 F 2d 330 (7th Cir 1979); *Laventhal, Krekstein, Horwath & Horwath v Horwath* 637 F 2d 672 (9th Cir 1980) cert den 452 US 963(1981); *Maryville Academy v Loeb Rhodes & Co* 530 F Supp 1061 (ND Ill 1981); *Kennedy, et al v Josephthal & Co, Inc* [1982-3

*Globus* the court had suggested an indemnity should not be enforceable in a “case where the underwriter has committed a sin graver than ordinary negligence.”<sup>115</sup> In *Gould v American-Hawaiian Steamship Co*<sup>116</sup> it was held that a person who is negligent will be denied contractual indemnification as “only a realistic possibility of liability for damages will encourage due diligence.”<sup>117</sup> Similarly in *Kennedy v Josephthal & Co*<sup>118</sup> the view was expressed that:

“it is the purpose of the federal securities laws to deter conduct that is merely negligent, as well as conduct that is wilful, knowing or reckless. This is particularly important when the acts in question are those of an underwriter.”<sup>119</sup>

The consequences of this approach were clearly demonstrated in *Odette v Shearson, Hammill & Co*<sup>120</sup>, where a negligent underwriter was denied indemnification from a party who had willfully violated the securities laws.<sup>121</sup>

Critical to the analysis in the *Globus Case* is the premise that deterrence is the primary function of the United States civil liability provisions. If the policy underpinning of the civil liability provisions had been considered to have a pure compensation focus there would be less public policy objection to an indemnity being available to the underwriter, provided the investor was properly compensated by someone.<sup>122</sup>

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Transfer Binder] Fed Sec L Rep (CCH) 99,204 (D Mass) (also denying indemnity under section 12(2)); *Seiler v E.F. Hutton & Co* [1984 Transfer Binder] Fed Sec L Rep (CCH) 91,632 (DNJ); *Delta Holdings Inc v National Distillers & Chemical Corp* [1986 Transfer Binder] Fed Sec L Rep (CCH) 92,910 (SDNY); *King v Gibbs* 876 F 2d 1275 (7th Cir 1989); *Eichenholtz v Brennan* 52 F 3d 478 (3d Cir 1995).

On the other hand there is a very limited body of case law that suggests that where an underwriter is significantly less culpable than the issuer an indemnity in the underwriting agreement might be enforceable: *Steinberg v Pargus Inc* [1984 Transfer Binder] Fed Sec L Rep (CCH) 91,979 at 90,882 (SDNY); *Adalman v Baker, Watts & Co* 599 F Supp 752 (D Md 1984) at 754. Clearly however that is a minority view.

<sup>115</sup> 418 F 2d 1276 at 1288.

<sup>116</sup> Supra note 114. The case involved a contravention of section 14(a) of the *Securities Exchange Act* 1934.

<sup>117</sup> Ibid at 168.

<sup>118</sup> Supra note 114.

<sup>119</sup> Ibid at 95,821-2.

<sup>120</sup> Supra Note 114.

<sup>121</sup> There is a small body of case law that might suggest a negligent party may be entitled to contribution, but that approach is clearly in the minority - see *Wassel v Eglowsky* 399 F Sup 1330 (M Md 1975); *Muth v Dechert, Price & Rhoads* 391 F Supp 935 (ED Pa 1975); *Getter v RG Dickinson & Co* 366 F Supp 559 (SD Iowa 1973).

An alternative proposition was put in *Ruder (1972)* that a degree of fault analysis should be applied where one of two persons is more culpable than the other. An indemnity held by the less culpable person would be capable of enforcement by strengthening deterrence against more grievous wrongs (see at 658). This approach has not found great support.

<sup>122</sup> The question has been posed as to whether indemnification of a participating underwriter in an underwriting syndicate is more acceptable than the general position in view of suggestions a lower standard of inquiry should apply and the practical impediments faced by a participating underwriter in verifying prospectus statements - see Cohen “*Symposium, The BarChris Case*” (1969) 24 Bus Law 523 at 551-2; *Note (1977)* at 92-3.

In addition to the case law noted above, the SEC has commented on indemnification arrangements. First the SEC's position is that indemnification arrangements in relation to directors, officers and controlling persons is against public policy and unenforceable.<sup>123</sup> That view is hardly surprising. Secondly, the SEC requires disclosure of contractual indemnification arrangements with underwriters in offering documents.<sup>124</sup>

Clearly the strong policy undercurrent of this analysis is that an indemnity would undermine the legislative scheme of the securities laws by removing the incentive to undertake independent inquiry in relation to prospectus disclosures.<sup>125</sup> The philosophical basis of that proposition is compelling in the case of the underwriter, but arguably less so for other professionals involved in the capital raising process because of the more limited role performed by those other persons.

It has been argued above that Australia's civil liability provisions demonstrate a similar deterrence policy basis of regulation to the United States provisions.<sup>126</sup> However, it might be questioned if an Australian court would concern itself with public policy issues in relation to the

<sup>123</sup> Item 512(i) of Regulation S-K promulgated by the SEC. No objection is made by the SEC to agreements between a controlling shareholder in a secondary distribution to indemnify the issuer and its directors and officers for the reason the offering is solely for the benefit of that selling shareholder - Item 512(i).

<sup>124</sup> Item 508(g) of Regulation S-K promulgated by the SEC. The indemnification arrangements typically provide that the underwriter indemnifies the issuer for information furnished by it and the issuer indemnifies the issuer for all other information - see *Donaldson, Lufkin & Jenrette Securities Corporation v Star Technologies, Inc* 561 NYS 2d 371. Also provided the "Johnson & Johnson formula" is applied (the indemnity is qualified to provide that it will not be honored without a judicial test if the matter is not settled by controlling precedent, except for the costs of a successful defence.) the SEC will permit acceleration of registration statements. For discussion see *Loss & Seligman (1995)* at 1150-1 and 109.

The failure of the SEC to vigorously object to underwriter indemnification practices has been criticised from the theoretical perspective as it is argued to undermine the deterrent effect of the legislation - see *Freund & Hacker (1973)* at 473; *Note (1977)* at 91; *Scott (1986)* at 240.

<sup>125</sup> See *Scott (1986)* at 245.

The ALI Federal Securities Code proposed a statutory prohibition on indemnification in the following terms (section 1724(e)(2)):

"Except for the expenses of a successful defense, and regardless of whether there is an indemnification provision in a statute, bylaw or similar instrument, or contract -

(A) a person (other than an underwriter) may be indemnified against liability (and attendant litigation expenses) under this Code (as defined in section 202(24) only to the extent that -

(i) the Commission provides by rule on consideration of such factors as the respective gains and losses of the indemnitor and indemnitee, the conduct of the indemnitee, and the deterrent effect of the particular type of liability; or

(ii) a court determines in accordance with the principles of common law and equity, applied as a matter of Federal jurisprudence without regard to the statutory or other law of any State, and on consideration of the factors specified in section 1724(e)(2)(A)(i);"

Underwriters are excluded from the section because of the historical failure of the Securities & Exchange Commission to address the issue, but in anticipation that the courts would in any event treat underwriter indemnification as void (see comment 4 and 5).

It has been argued on the other hand that there should be no policy objective for underwriters indemnifying each other if they so choose (for example the manager of a syndicate indemnifying syndicate members) - see *Note (1977)* at 92.

<sup>126</sup> At the policy level it has been argued that risk shifting should be defended only if absolute personal liability does not contribute to deterrence or if contribution is offset by the costs imposed on innocent parties - see *Kraakman (1984)* at 862.

enforcement of a contractual indemnity provision. There is analogous case law precedent for such an approach to be applied.

There is a long line of authority for the proposition that an indemnity for the recovery of costs and fines incurred as a result of intentional criminal conduct will not be enforced on public policy grounds. The leading early authority for this proposition is *Colburn v Patmore*.<sup>127</sup> The position was best put in *Burrows v Rhodes & Jameson*<sup>128</sup> by Kennedy J:

“It has, I think, long been settled law that if an act is manifestly unlawful, or the doer of it knows it to be unlawful, as constituting either a civil wrong or a criminal offence, he cannot maintain an action for contribution or for indemnity against the liability which results to him there from. An express promise of indemnity to him for the commission of such an act is void.”<sup>129</sup>

The case law has since developed on this basis.<sup>130</sup> The genesis of that principle from similar policy considerations as *Merryweather v Nixan* discussed above are obvious.

The issue for determination is whether this public policy argument will be extended to prospectus misstatement liability as in the United States, either on the negligence criteria of the prospectus liability provisions of the *Corporations Act* or the innocent misconduct criteria of the *Misleading & Deceptive Conduct Provisions*. There are two English cases that deal directly with indemnities given in relation to misstatements.

In *Brown Jenkinson & Co Ltd v Percy Dalton (London) Ltd*<sup>131</sup> an indemnity was granted by the owner of goods (orange juice) to a shipowner in connection with the issue of a bill of lading by the shipowner containing a representation that the goods were in good order. In fact, both the owner and the shipowner knew the goods to be defective, although the shipowner was found not to have made the representation in the bill of lading with the intention that it should be acted upon by any third party purchaser of the orange juice. The shipowner ultimately was required to pay

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<sup>127</sup> *Colburn v Patmore* (1834) 149 ER 999; 1 CM&R 73 (the case involved the publisher of a journal seeking to recover criminal fines from his editor, the fines being incurred by the editor publishing a libel). By way of obiter dictum Lord Lyndhurst CB said:

“I know of no case in which a person who has committed an act, declared by the law to be criminal, has been permitted to recover compensation against a person who has acted jointly with him in the commission of the crime ... I entertain little doubt that a person who is declared by the law to be guilty of a crime cannot be allowed to recover damages.” (at 1003)

<sup>128</sup> *Burrows v Rhodes and Jameson* [1899] 1 QB 816 (the case involved an action against Cecil Rhodes by one of his soldiers for damages suffered in invading South Africa through allegedly fraudulent representations made by Rhodes that the invasion was sanctioned by England).

<sup>129</sup> *Ibid* at 828.

<sup>130</sup> See *Leslie (R) Ltd v Reliable Advertising and Addressing Agency Ltd* [1915] 1 KB 652; *Askey v Golden Wine Co Ltd & Ors* [1948] 2 KB 35.

<sup>131</sup> *Brown Jenkinson & Co Ltd v Percy Dalton (London) Ltd* [1957] 2 QB 621.

compensation to the purchaser of the goods and claimed against the owner for the compensation it had paid on the basis of the indemnity. The indemnity given by the owner to the shipowner was held to be unenforceable.

The English Court of Appeal considered that all the elements of the tort of deceit were present in relation to the representations made by the shipowner in the bill of lading (albeit at the request of the owner) and, as a consequence, the indemnity could not be enforced:

“Can A, who does what B asks him to do, enforce against B a promise made in the following terms: ‘If you will at my request make a statement which you know to be false and which you know will be relied upon by others and which may cause them loss, then, if they hold you liable, I will indemnify you?’ In my judgment, the assistance of the courts should not be given to enforce such a promise.”<sup>132</sup>

To similar effect in *Askey v Golden Wine Co Ltd & Ors*<sup>133</sup> Denning J refused to enforce an indemnity given by the manufacturer of wine to a distributor of the product. The manufacturer had previously been criminally prosecuted under the *Foods and Drugs Act* for the sale of unfit wine. The distributor purchased additional wine on the basis of verbal assurances made by the manufacturer that the wine no longer contravened the legislation and was now fit for sale. The distributor was then successfully criminally prosecuted for the sale of the additional wine as unfit wine. In addition, unsold wine was returned to the distributor by retailers and the distributor was required to pay compensation in relation to those returns. The indemnity given by the manufacturer to the distributor in relation to the criminal fines for sale of the wine was invalidated on the basis of the principles referred to above.<sup>134</sup> The indemnity for compensation paid to retailers by the distributor was also invalidated on the basis that the distributor had been guilty of “gross negligence” and:

“So important is this that the Food and Drugs Act, 1933, makes his conduct criminal unless he can prove that he acted with due diligence ... if they were allowed to be negligent and yet recover damages, it would offer an inducement to them to turn a blind eye to contamination. Take the present case. The £300 or £400 which the plaintiff had to pay in fines and costs is a trifling sum compared to the large profits he has made. If he is

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<sup>132</sup> Ibid at 635 (per Morris LJ). Lord Evershed MR wrote a strong dissent to the effect that the principle of “ex turpi causa non oritur actio” should not deny relief in the absence of personal dishonesty on the part of the person seeking to enforce the contract. It was found as a matter of fact that the plaintiff had honestly believed that the false statement would not damage anyone (ibid at 650).

<sup>133</sup> *Askey v Golden Wine Co Ltd & Ors* [1948] 2 KB 35.

<sup>134</sup> The *Food and Drugs Act* 1938 made a distributor’s conduct criminal unless he could prove he acted with “due diligence” - Ibid at 39. The parallels to securities regulation are obvious.

left himself to bear the loss of the £1735 refunded to the retailers, it will tend to reduce the profits and thus be an added deterrent.”<sup>135</sup>

The parallels between this quote from the *Askey* decision and the position of participants involved in the capital raising process under the securities laws are obvious.<sup>136</sup>

In contrast to the *Brown Jenkinson* and *Askey* cases described above, there are a number of insurance cases where courts have refused to invalidate insurance policies, even where the insured has been criminally negligent.<sup>137</sup> In reviewing this body of law, the New South Wales Court of Appeal summarised the position as follows:

“the law, and in particular the law relating to insurance, has distinguished between intentional crimes and crimes which are not intentional but are the consequence of negligence, however gross.”<sup>138</sup>

The difficulty is that this conclusion is based on the same public policy cases as are referred to in the *Brown Jenkinson* and *Askey* cases. In the *Askey* case, earlier insurance cases were distinguished on the basis that in the insurance cases the act indemnified against is one intended by the law to be insured against.<sup>139</sup> From the policy perspective, this would seem to be a valid distinction to make in that there is a clear inequity in an insurer representing it will hold a person harmless from damage caused through negligence, receiving payment for the policy issued and then seeking to release itself from the claims made on the grounds of public policy. In addition,

<sup>135</sup> Ibid at 39.

<sup>136</sup> A qualification to the above analysis is the decision of *Burrows v Rhodes & Jameson* noted above. In that case recovery of damages was argued to be impossible on the basis that the plaintiff as well as the defendants had been engaged in a criminal act (the invasion of South Africa) (It was assumed the invasion of a neutral country was a criminal offence under the *Foreign Enlistment Act 1870* (England)). That claim was not struck out on the principle of *Colburn v Patmore* because the plaintiff had been induced to believe, and did believe, that the acts in question were neither criminal or immoral. It was held that there would be no right of indemnity if the complainant knew the act to be a criminal offence or knew of all the circumstances necessary to constitute the offence even if ignorant of the offence itself or knew that the act was morally wrong (See *Burrows v Rhodes & Jameson* at 829). The qualification demonstrated by this case are unlikely to be of much relevance to the prospectus context.

<sup>137</sup> See *Tinline v White Cross Insurance Association, Ltd* [1921] 3 KB 327; *James v British General Insurance Company Ltd* [1927] 2 KB 311; *Australian Aviation Underwriting Pty Ltd v Henry & Anor* (1988) 12 NSWLR 121.

<sup>138</sup> See *Australian Aviation Underwriting Pty Ltd v Henry & Anor* (1988) 12 NSWLR 121 per Hope JA at 124. The English Court of Appeal has suggested that if the conduct in question is “wilful or culpable” no recovery is permitted - *Gray & Anor v Barr, Prudential Assurance Co. Ltd (Third Party)* [1971] 2 QB 554 at 568 (Lord Denning MR) (public policy will not permit insurance policy to be enforced where a claim was made for manslaughter caused by gunshot).

<sup>139</sup> Denning J in *Askey v Golden Wine Co Ltd* referring to comments of Greer LJ in *Haseldine v Hoskin* [1933] 1 KB 838. Reference to the early insurance cases cast doubt on the distinction drawn by Denning J. For example in the *James* case, Roche J was quite explicit that negligence, whether gross or reckless, would not have the degree of criminality to make it against public policy to permit indemnification (at 323).

Insurance of prospectus law liability is also an issue that must be considered in the Australian context - such insurance is available (at a cost) to directors of issuers.

On the other hand, after the 1960s, insurance of that nature became unavailable in the United States - see *Freund & Hacker (1974)* at 171, footnote 62. In the United States, if available, insurance is not perceived to be objectionable - see Rule 461(c) promulgated by the Securities Exchange Commission under the *Securities Act 1933* and Romano “*What Went Wrong with Directors’ and Officers’ Liability Insurance*” (1989) 14 Del J Corp L 1.

insurance serves a valuable social function in removing the need for injured people to turn to the social security system for support. The public policy concerns in the insurance area suggest that insurance policies should be upheld.

Similarly in the trustee area, contractual trustee exculpation clauses are only invalid to the extent they purport to exclude fraud. Contractual exculpation for negligence, no matter how gross, will not be struck down as being against public policy.<sup>140</sup>

On the other hand, if the underpinnings of the prospectus liability provisions of the *Corporations Act* are accepted to be deterrence, the analysis of the *Brown Jenkinson* and *Askey* cases are much more relevant than these cases.<sup>141</sup> The lessons for participants involved in the capital raising process must be that, under an indemnity given by the issuer, criminal fines cannot be recovered, intentional or wilful civil liability payments are unlikely to be recovered, and liability payments under the *Corporations Act* where the Part 6D.3 defences are not established are possibly not recoverable.<sup>142</sup> On the other hand indemnities for innocent misstatements under the *Misleading & Deceptive Conduct Provisions* are more likely to be enforceable.

Despite the frequent invalidation of contractual indemnity clauses in United States underwriting agreements, it is still the practice to include such provisions as a matter of course. The reasons typically given for this practice are that the existence of such a clause will be of some assistance to an underwriter in exerting commercial leverage against an issuer in settlement negotiations and will be of assistance in ensuring the underwriter can pass on the costs of litigation to the issuer before any finding of liability is made.<sup>143</sup>

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<sup>140</sup> See *Armitage v Nurse & Ors* [1997] 2 All ER 705. Again, the comment was made that English law distinguishes between fraud and negligence as the relevant boundary for these purposes (Millet LJ at 713-715).

<sup>141</sup> Compare *Strongroom (1945) Ltd v Sincock* [1955] 2 QB 525. That case involved a builder relying on a statement from its architect client that necessary building approvals to construct a building were in place. The building approvals had not been obtained by the client and the client claimed illegality to prevent the builder enforcing its building contract. It was held by the English Court of Appeal that while the failure to obtain building approvals may have constituted a criminal act on the part of the builder he could enforce the contract provided he had not been guilty of culpable negligence (no fault was established on the part of the builder in obtaining the approvals) - Denning LJ at 536-7.

<sup>142</sup> In contrast to the ambiguity of the *Corporations Act* position, the *Corporations and Securities Bill 1974* had proposed a prohibition on persons facing potential liability for prospectus misstatement indemnifying each other for any compensation that might be payable (section 171(10)). Section 171(11) provided such an arrangement would be unenforceable.

While the policy approach of those provisions may be subject to debate, at least the draft legislation proposed commercial certainty on the issue.

<sup>143</sup> See *Scott (1986)* at page 233, footnote 36.

### Exclusions from Indemnity

An issue of peripheral relevance to the policy issues outlined above, but of great relevance to market practice, relates to the legal analysis surrounding the carve outs from any indemnity given.

In Australian underwriting agreements it is typical for the underwriters indemnity to be qualified by reference to the “fraud”, “wilful default” or “gross negligence” of the underwriter. In addition, some underwriting agreements exclude the “negligence” or “breach of law” of the underwriter.

The exact formulation of the exclusions in Australia remains the subject of negotiation between the issuer and underwriter, rather than a matter of industry practice, which is more the case in the United States. Typically, there will be a debate as to whether negligence or “gross” negligence of the indemnified party should be excluded. That terminology might be considered to come from the United States where that formulation is a standard exclusion from the indemnity.

The meaning to be attributed to the term “fraud” is quite clear and refers to the tortious measure of deceit as exemplified in *Derry v Peek*.<sup>144</sup>

The term “wilful default” on the other hand requires greater analysis. Case law relating to the term arises in the context of trust law and exculpatory language used in contracts.

The best starting point of analysis are cases relating to contractual provisions excluding wilful default, wilful misconduct or wilful neglect. The leading case is *In Re City Equitable Fire Insurance Company Limited*<sup>145</sup> which involved consideration of exculpatory language in the articles of association of the relevant company to the effect that directors, officers and auditors would only be liable for their acts if arising as a result of “wilful neglect or default”. While there was some evidence of negligence on the part of non-executive directors and the auditor, it was found that each was acting innocently and without notice of the fraud committed by the chairman and managing director of the company. Such conduct was held not to constitute wilful neglect or default within the meaning of the article:

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<sup>144</sup> As a matter of contractual construction the term “actual fraud” used in an exclusion clause for a trustee in a trust deed has been considered to equate with dishonesty as demonstrated by the level of culpability in *Derry v Peek* rather than any lower level of culpability - *Armitage v Nurse & Ors* [1997] 2 All ER 705 at 710-1.

<sup>145</sup> *In re City Equitable Fire Insurance Company, Limited* [1925] 1 Ch 407.

“The difficulty is not so much in ascertaining the meaning of the adjective “wilful” as in ascertaining precisely what is the noun to which the adjective is to be applied. An act, or omission to do an act, is wilful where the person of whom we are speaking knows what he is doing and intends to do what he is doing. But if that act or omission amounts to a breach of his duty, then therefore to negligence, is the person guilty of wilful negligence? In my opinion that question must be answered in the negative unless he knows what he is committing, and intends to commit, a breach of his duty, or is recklessly careless in the sense of not caring whether his act or omission is of or is not a breach of duty.”<sup>146</sup>

As such, it is necessary to establish that person was conscious that the act done was a breach of duty or in acting the person was reckless.<sup>147</sup> That decision is also consistent with a line of earlier contract cases.<sup>148</sup>

On the other hand the Australian law relating to the term “gross negligence” is confused. Gross negligence initially developed in this jurisdiction in connection with a gratuitous bailee of goods being responsible to an injured person in tort. In that situation the case law suggests the use of the term “gross” does not alter the essential nature of the standard of liability required.<sup>149</sup>

<sup>146</sup> Ibid at 434 (Romer J).

<sup>147</sup> To similar effect see Court of Appeal Ibid at 516-7 (Pollock MR); 521-5 (Warrington LJ); at 528-9 (Sargant LJ). See also *Re Vickery* [1931] 1 Ch 572 at 583.

In Australia see *Gould v The Mount Oxide Mines Limited (In Liquidation) & Ors* [1916] 22 CLR 490 (similar exculpatory language in articles of association) and *Perpetual Trustee Co v Watson (No. 2)* (1927) 28 SR NSW 43; *Dalrymple v Melville* (1932) 32 SR NSW 597 (trustee cases).

<sup>148</sup> See *Lewis v Great Western Railway Company* (1877) 3 QBD 195 (contract for carriage of goods excluded liability except for wilful misconduct of servants); *Forder v Great Western Railway Company* [1905] 1 KB 532 (similar contract case); *In re Trusts of Leeds City Brewery, Limited's Debenture Stock Trust Deed; Leeds City Brewery, Limited v Platts* [1925] 1 Ch 532 (debenture trust deed excluded liability of trustee except where wilful default).

The decision is also consistent with *In re Brazilian Rubber Plantations and Estates, Limited* [1911] 1 Ch 425 where an article excluding director liability except for “dishonesty” was held to exclude liability where directors acted honestly but negligently (at 440 per Neville J).

In the *City Equitable Case* a line of trust cases were noted that suggests wilful default might merely require that the relevant person does the action freely, albeit only negligently or with innocent intent. See *In re Brier* 26 Ch D 238; *Dix v Burford* 19 Beav 409; *Mucklow v Fuller* Jac 198 discussed in the *City Equitable case* at 438-441. These cases dealt with section 31 of *Lord St Leonard's Act* which provided a trustee would not be responsible for lost trust money unless the loss happened through wilful fault. In addition, in the property law case of *In re Young and Harston's Contract* 31 Ch D 168 (default interest payable on delayed settlement unless wilful default be vendor) such an interpretation was argued (see Bramwell LJ at 174). However *In re Mayor of London and Tubb's Contract* [1894] 2 Ch 524 (similar trusts) it was pointed out that the facts in *In re Young* did not demonstrate an honest oversight on the part of trustee - an approach similar to the *City Equitable Case* was instead adopted.

However, those cases required a finding of wilful action as a threshold for potential liability. As stated in the *City Equitable Case*, that line of cases do not sit well in the context of wilful action as the basis of the exculpation from liability. See *Romer J* Ibid at 431. See also *Armitage v Nurse & Ors* [1997] 2 All ER 705 at 712 and *Wilkinson & Ors v Feldworth Financial Services Pty Ltd & Ors* (1999) 29 ACSR 642 (SC NSW, Rolfe J) at 696-702.

The approach of the *City Equitable Case* is to be preferred in the context of an indemnity qualification.

<sup>149</sup> *Hinton v Dibbin* (1842) 2 QB 646; *Owen v Burnett* (1834) 2 Cr & M 353; *Goodman v Harvey* (1836) 111 ER 1011; *Austin v Manchester, Sheffield & Lincolnshire Rly Co* (1852) 10 CB 454; *Cashill v Wright* (1856) 6 E&B 891; *Grill v General Iron Screw Collier Co* (1866) 35 LJCP 321, LR 1 CP 600, LR 3 CP 476; *Martin v London County Council* [1947] KB 628; *Pentecost v London District Auditor* [1951] 2 All ER 330. Part of the difficulty with the case law is the criminal law suggestion that for negligence to give rise to criminal consequences (for example in manslaughter) the negligence must be “culpable”, “gross”, “wicked” or “clear”, being negligence showing disregard for life and safety of others - see *Andrews v Director of Public Prosecutions* [1937] AC 576 at 582-3.

This case law precedes the modern development of the torts of negligence and deceit and relates to the imposition of tortious liability in particular circumstances.<sup>150</sup> It can be expected a different approach might apply where parties agree to use the term in the context of contractual rights. In these circumstances there is a greater likelihood the court may apply greater significance to the conscious decision of parties entering contractual relations to select the term “gross”.<sup>151</sup> It can be argued that if the parties bargain for the additional requirement that the conduct be “gross” the courts will seek to give effect to the parties intention. In that respect it would be a question of fact as to whether the conduct in question was “gross negligence” having regard to the deviance from the standard of conduct of a reasonable person in the circumstances.

That type of analysis is supported by Canadian case law that suggests a contractual specification of gross negligence will connote a degree of recklessness or extreme negligence.<sup>152</sup> United States law similarly accepts a distinction between negligence and gross negligence based on a greater lack of care than with ordinary negligence.<sup>153</sup>

Unlike the qualifications described above, underwriting agreements that exclude an underwriter’s indemnity for “negligence” or “breach of law” clearly do not achieve a significant shifting of risk from the indemnified party.

If the indemnified person has failed to establish its due diligence defences under the law that is likely to be analogous to a showing of negligence at general law. The relationship between

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In the *Grill* case Willes J famously observed that gross negligence is ordinary negligence with a vituperative epithet (35 LJCP at 330).

<sup>150</sup> In *Armitage v Nurse & Ors* [1997] 2 All ER 705 the observation was made this flows from the English law traditional distinction between negligence, however gross, and fraud (this case concluded that a contractual trustee exclusion would be void to the extent it excluded fraud but not void to the extent “gross negligence” is sought to be excluded).

In the tort context it has been said

“The use of the expression ‘gross negligence’ is always misleading. Except in the one case when the law relating to manslaughter is being considered, the words ‘gross negligence’ should never be used in connection with any matter to which the common law relates because negligence is a breach of duty, and, if there is a duty and there has been a breach of it which causes loss, it matters not whether it is a venial breach or a serious breach” - *Pentecost v London District Auditor* [1951] 2 KB 759 (Lord Goddard CJ).

<sup>151</sup> In *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 All ER 98 the House of Lords has affirmed the proposition that technical legal terms used in a contractual document should be construed in the manner the language would have been understood by a reasonable man (Lord Hoffman at 114-5).

<sup>152</sup> *Osmond v McColl Frontenac Oil Co Ltd* (1939) 47 Man LR 176; *Murray v McCollock* [1941] 3 DLR 42; [1942] SCR 141; *Paul v Dauphin* [1941] 1 WWR 43; [1941] 2 WWR 224; *Scardina v La Roche* [1951] 1 DLR 117; *Jackson v Millar* [1973] 1 OR 399.

<sup>153</sup> See for example “*New York Jurisprudence*”, Negligence, section 37. The negligence must be of an aggravated character generally involving a disregard of the consequences that ensue from an act and indifference to the rights of others. As such, gross negligence approaches the characteristics of recklessness underlying the tort of deceit.

In *Garrison v Pacific Northwest Bell* 618 P 2d 1206 (1980) gross negligence was characterised as conscious indifference or reckless disregard of the rights of others. For discussion of the relationship between gross negligence and recklessness see *In Re National Smelting of NJ* 722 F Supp 152 (DNJ 1989); *Hoffman v Estabrook & Co* 587 F 2d 509 (1st Cir 1978).

failure to establish a due diligence defence and negligence has previously been discussed.<sup>154</sup> This means that an indemnity with such an exclusion is likely to be only useful to the indemnified party in facing misleading conduct liability but not liability under Part 6D.3 itself.

A breach of law exclusion provides even less protection to an indemnified person. If a participant involved in the capital raising process faces civil liability for a prospectus misstatement that liability will arise as a result of a breach of law - Part 6D.3 or the misleading conduct statutes. As the statutes impose primary liability on the underwriter for the disclosures in the disclosure document the protection afforded by the indemnity to the underwriter will essentially be useless. Such an exception subsumes the indemnity.

### Contractual Contribution Clauses

In view of the likely suspicion with which courts will treat contractual indemnification provisions the question must be asked if there is any other contractual risk shifting regime that may have a greater chance of success. This search is pressing in Australia in view of the inadequate coverage of principles of contribution under Part 6D.3 of the *Corporations Act*. The solution is to consider the introduction of contractual contribution arrangements as between participants in the capital raising process.

Contractual contribution clauses first appeared in the United States in the late 1960s following the judicial rejection of contractual indemnification clauses in underwriting agreements.<sup>155</sup>

Contractual contribution clauses are not yet a customary feature of Australian underwriting agreements.

As has been described above, statutory contribution is an accepted feature of the United States securities laws. It has been suggested that contribution, unlike indemnity:

“strengthens the policy underlying the securities laws. As between the culpable parties, contribution reinforces the deterrent effect of the statute by preventing one wrongdoer from unjustly escaping loss by shifting its responsibility to another wrongdoer liable for the same payment”<sup>156</sup>

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<sup>154</sup> See Section 4.3.

<sup>155</sup> See *Scott (1986)* at 231 and *Freund & Hacker (1974)* at 474. It had long been suggested that contractual contribution was permitted - see *Bates & Douglas (1933)* at 179 citing both English and United States case law.

<sup>156</sup> *Laventhal, Krekstein, Horwath & Horwath v Horwitch* 637 F 2d 672 (9th Cir 1980) cert den 452 US 963 (1981) at 975. See also *Scott (1986)* at 246.

This philosophy echoes the underpinnings expressed in *Albion Insurance Company Limited v Government Insurance Office of New South Wales* in the Australian context. As pointed out there, principles of fairness suggest all persons with responsibility share the relevant loss and that it not be left to the plaintiff to capriciously select who should have responsibility for any damages award.

It would seem that Australian and Commonwealth courts, like United States courts, have not had difficulty with the concept of contractual sharing of liability.<sup>157</sup> However the difficulty with contractual contribution from the policy perspective is that it can be agreed to share risk on such a one-sided basis that the contribution becomes de facto indemnification.

It would seem that the contribution clauses actually used in the United States suffer from that criticism. In underwriting agreements in the United States, contractual contribution clauses generally take one of two forms.

In the first, the so called “relative benefit” clause, liability is expressed to be shared based on the difference in benefits received by the various parties to the transaction.<sup>158</sup> In the case of the underwriter the benefit would be the fees earned by the underwriter from the transaction, while in the case of the issuer the benefit would be the proceeds of the issue received by the issuer. In this situation the gross imbalance of benefits is immediately obvious. In Australia the transaction fees earned by an underwriter are typically 1% to 5% of the proceeds of the issue received by the issuer and, on that basis, liability would be shared between the issuer and the underwriter for underwriter liability in those proportions.

The alternative form of contractual contribution clause, the so called “relative fault/relative benefit” clause contemplates contribution based on a consideration of the relative fault of the parties in connection with the misstatement as well as the relative benefits received by the parties. The relative benefit aspect of contribution is as described above. The relative fault criteria generally requires regard to be had to the source of the information which gave rise to the

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<sup>157</sup> See for example *Pendlebury v Walker* (1841) 4 YY&C.Ex. 424, 160 ER 1075; *Batard v Hawes*, *Batard v Douglas* (1853) 2 EL&BL 287, 118 ER 775 (at 297); *In re Sir JJ Ennis*, *Coles v Peyton* [1893] 3 Ch 238.

<sup>158</sup> See *Scott* (1986) at 232. The example relative benefit clause given was as follows:

“If the indemnification provided in this section is unavailable or insufficient to hold harmless ... then each indemnifying party shall contribute ... in such proportion as is appropriate to reflect the relative benefits received by the Company on the one hand and the Underwriters on the other from the offering of the Shares. The relative benefits received by the Company on the one hand and the Underwriters on the other shall be deemed to be in the same proportions as the total net proceeds from the offering (before deducting expenses) received by the Company bear to the total underwriting discounts and commissions received by the Underwriters, in each case as set forth in the table on the cover page of the Prospectus.”

misstatement, the parties relative intent, relative knowledge, access to the relevant information and opportunity to correct the misstatement.<sup>159</sup> Even in this situation it is obvious the most likely result is that the issuer will be more at “fault” than the underwriter, in view of the fact that the information used in the prospectus will come from the issuer.<sup>160</sup>

In the United States there is little judicial authority on the enforceability of a contractual contribution clause - either the relative benefits clause or the relative fault/relative benefit clause.<sup>161</sup> The difficulty with these clauses is that they blur the borderline between complete risk shifting and an appropriate sharing of liability for persons jointly responsible for loss.

It is generally considered in the United States that the enforceability of a relative benefit contractual contribution clause is highly suspect on the basis that it constitutes a de facto indemnity.<sup>162</sup> As with indemnity, such a one-sided sharing of loss does not further policy objectives of deterrence. The rejection of a benefits received basis for contribution under section 11(f) of the *Securities Act* was noted in the case law referred to above.

In addition the relative fault/relative benefit clause is also treated with suspicion. While the clause, on its face, seems unobjectionable as it contemplates a sharing of responsibility based on fault, it fails to recognise the role of the participants in the capital raising process rather than their relative functions. The clause tends to use criteria of sources of information, access to information and opportunity to correct misstatements that emphasise the position of the issuer as provider of information, instead of the role that should be performed by participants in the capital raising process - for example the role of “devil’s advocate” and of verification that should be performed by the underwriter.

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<sup>159</sup> *Scott (1986)* at 232-233. The example relative fault/relative benefit clauses given was as follows:

“[relative benefit clause as in the preceding note.] If, however, the allocation provided by the immediately preceding sentence is not permitted ... then each indemnifying party shall contribute ... in such proportion as is appropriate to reflect not only such relative benefits but also the relative fault of the Company on the one hand and the Underwriters on the other ... The relative fault shall be determined by reference to, among other things, whether the untrue or alleged untrue statement of a material fact or the omission or alleged omission to state a material fact relates to information supplied by the Company on the one hand or the Underwriters on the other and the parties’ relative intent, knowledge access to information and opportunity to correct such statement or omission.”

<sup>160</sup> The position of contractual contribution has also been addressed in the United States as between managing underwriters and participating underwriters in underwriting syndicates (section 11(f) does not provide a straightforward solution as between underwriters in a syndicate). It has been suggested in this type of situation contribution based on the percentage of the offering underwritten is the most appropriate approach having regard to issues of fairness and certainty - see *Freund & Hacker (1974)* at 483-490.

<sup>161</sup> *Scott (1986)* at 225.

<sup>162</sup> See *Gould v American-Hawaiian Steamship Company* supra note 114 at 171; *Scott (1986)* at 267; *Note (1977)* at 103.

The clause therefore seeks to distort the relative fault rule to focus on responsibility issues over legal fault.<sup>163</sup> For this reason, commentators have suggested that judicial recognition of such a clause should be resisted as it would change the statutory balance of the underwriter/issuer relationship.<sup>164</sup> The obvious intention of the clause is to move liability away from the underwriter onto the issuer, again giving rise to the criticism of de facto indemnification.<sup>165</sup>

It is interesting to note that the ALI proposed Federal Securities Code was supportive of contractual contribution.<sup>166</sup> However there is no analysis in the notes to the code of the policy difficulties that have been referred to above.

The observations made by United States commentators on the position of contractual contribution clauses should apply with similar weight in Australia if it is assumed that Australian courts will adopt a comparable role in relation to indemnification and risk shifting issues as is generally applied by the United States courts.<sup>167</sup> Clearly such an approach is sound from the policy perspective.

However, the basis for the inclusion of a contractual contribution clause in an underwriting agreement in Australia is much more pressing than in the United States. The failure of Australian law to recognise rights of contribution clearly militate in favour of the development of contractual contribution arrangements in Australian underwriting agreements, even if the sharing is only on a basis of relative fault and the source of the misstatement (to address the policy concerns identified above).

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<sup>163</sup> See *Scott (1986)* at 268-9; *Note (1977)* at 103.

<sup>164</sup> *Scott (1986)* at 269. On the other hand such an approach has been considered to be appropriate in underwriting syndicates in the apportionment of loss between lead underwriters (who undertake due diligence inquiries) and other syndicate members - see *Klinges* (1985) at 1086-7.

<sup>165</sup> See *Scott (1986)* at 268-9; *Note (1977)* at 103. See also the criticism of this basis of allocation by the United States courts as a basis of contribution awards in Section 10.2.

<sup>166</sup> See Section 1724(f)(i) which provides:

“To the extent consistent with section 1724(e) -

(1) two or more persons liable in an action created by or based on a violation of this Code (as defined in section 202(24)), may allocate liability among themselves by contract made either before or after liability is imposed;

(2) ...

except that no such person may be ordered to pay more under section 1724(f) than what his maximum liability would have been if he had been a defendant in the action giving rise to the action for contribution.”

<sup>167</sup> If contractual contribution clauses, as formulated in the United States, are of dubious enforceability it might be questioned why United States underwriters persevere with them. Lack of judicial scrutiny may be one reason. The principal reason would appear to be the same as for the continued use of contractual indemnities - leverage against the issuer in settlement negotiations (see *Scott (1986)* at footnote 191, page 257).

## Waivers & Disclaimers

A final issue of relevance to the analysis of risk shifting under the *Corporations Act* is the use of disclaimer and waiver provisions by participants involved in prospectus preparation in an attempt to remove potential liability.

The practical question is often posed as to whether it would be possible to require subscribers for shares to consent to a disclosure document that does not satisfy the contents requirements for prospectus disclosure. Such a proposal would constitute a waiver of statutory rights by the subscriber.

An alternative way in which the issue may arise is through the inclusion of a disclaimer of liability in the prospectus. It is frequently the case in Australian prospectuses that a participant involved in the capital raising process will qualify its consent to the inclusion of its name in the prospectus, as described in the prospectus, by the addition of language that the person disclaims all liability for the disclosures contained in the prospectus.

From the policy perspective, this type of waiver or disclaimer should clearly not be countenanced, except where the subscriber for securities is placed in an equal position of knowledge concerning the affairs of the issuer.

It is interesting to note that waiver clauses were a common feature of prospectuses at the end of the nineteenth century. This would seem to have been a response by the financial community to the introduction of the *1867 Material Contracts Act*. The English courts were united in rejecting the effectiveness of such a waiver as a shield from liability.

A good illustration of this is reflected by the 1904 decision of *De La Cour v Clinton-Trechmann v Calthorpe*.<sup>168</sup> The relevant prospectus referred to the acquisition by the issuer of a business from the promoter. It was noted that the business to be acquired was subject to numerous contracts entered into in the ordinary course, which may technically come within the disclosure requirements of the relevant legislation. Applicants were required to waive any right to be provided with details of any such material contracts.<sup>169</sup>

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<sup>168</sup> *De La Cour v Clinton-Trechmann v Calthorpe* (1904) 20 TLR 420 (Joyce J); 20 TLR 706 (Court of Appeal).

<sup>169</sup> The prospectus provided:

“Applicants for shares are to be deemed to have had notice of all the contracts referred to in this prospectus and to have agreed with the company (contracting on behalf of the directors and other persons responsible) to waive their rights (if any) to further particulars as to the dates, the names of the parties or otherwise, and must accept this notice as sufficient compliance with the said section” (Ibid at 707)

The Court of Appeal considered such an approach to disclosure as unacceptable:

“It is impossible to read this clause without seeing that it is a tricky clause, intended to deceive.”<sup>170</sup>

Notwithstanding this approach, it was suggested by the House of Lords in *Macleay v Tait*<sup>171</sup> that a clause in a prospectus purporting to protect the promoters or directors from an omission was, if made in good faith, effective to protect those persons.

The position is now reinforced by *CA* section 703, which provides that a condition for the sale or issue of securities is void if:

- it requires or binds an investor to waive compliance with any requirement of Chapter 6D;
- it provides the investor is taken to have notice of any contract, document or matter not specifically referred to in the disclosure document.

This provision was first inserted into Australian legislation in the *Companies Act 1936* (New South Wales)<sup>172</sup> and is based on the predecessor English legislation.

A useful counterpoint to the above analysis is the case law analysis surrounding disclaimers in connection with claims brought under the *Misleading and Deceptive Conduct Provisions*. Disclaimers are generally considered ineffective unless there is an absence of reliance.<sup>173</sup> For example, in *Mackman v Stengold Pty Limited*<sup>174</sup> a disclaimer in relation to financial information said to be provided by accountants was held to be ineffective.<sup>175</sup> As such, waivers and disclaimers are unlikely to be an effective mechanism to shield liability.

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<sup>170</sup> Ibid at 709 (Court of Appeal). The facts of the case indicated that the relevant material contract had been disclosed in an early draft of the prospectus but was then omitted in the final document with the waiver clause redrafted in an attempt to cover the omitted contract. See also *Greenwood v Leather Shod Wheel Company* [1900] 1 Ch 421 (at 436 per Lindley MR in relation to a promoter); *Gluckstein v Barnes* (1900) AC 240 (promoter case) and *Omnium Electric Palaces v Baines* [1914] 1 Ch 247.

<sup>171</sup> *Macleay v Tait* (1906) AC 24. See also *Cackett v Keswick* [1902] 2 Ch 456 at 476 (Vaughan Williams LJ); *Watts v Bucknall* [1903] 1 Ch 766 at 776-7 (Collins MR); *Macleay v Tait* [1906] AC 24 at 34 (Lord Lindley); *Mair v Rio Grande Rubber Estates, Limited* [1913] AC 843 at 872 (Lord Moulton)

<sup>172</sup> Section 137(2) of the *Companies Act 1936* (New South Wales).

<sup>173</sup> See *Henjo Investments Pty Ltd & Ors v Collins Marrickville Pty Ltd* (1988) 79 ALR 83 (FCA, Lockhart, Burchett & Foster JJ) at 98-9; *Waltrip Pty Ltd & Anor v Capalaba Park Shopping Centre Pty Ltd* (1989) ATPR 40-975 (FCA, Pincus J); *Lezam Pty Ltd v Seabridge Australia Pty Ltd* (1992) 107 ALR 291 (FCA, Burchett J).

<sup>174</sup> *Mackman v Stengold Pty Ltd & Ors* (1991) ATPR 41-105 (FCA, Spender J).

<sup>175</sup> The information was totally and uncritically accepted by the accountant and was misleading (at 52,629).

## CHAPTER 11

### CONCLUSION AND SOME KEY POINTS

One objective of this dissertation has been to identify deficiencies in the structure of the Australian regime of prospectus misstatement liability having regard to technical case law analysis, relevant policy considerations and comparative analysis. The various threads of that component of the analysis are drawn together in summary fashion in this conclusion chapter.

#### 11.1 THE DEFICIENCIES CAUSED BY UNENFORCED LAWS

The lack of enforcement history of Australia's prospectus laws was noted at the outset. The enforcement record has not improved over the last 10 years under the *Corporations Law* and the *Corporations Act*.

The pivotal role performed by a properly structured system of sanctions is recognised as fundamental to a properly operating mandatory disclosure regime, irrespective of whether an orthodox approach to the policy underpinnings of mandatory disclosure is taken or (for example) the views of the information economists are followed. As such the effectiveness of the sanctions contained in Part 6D.3 of the *Corporations Act* is critical to the proper operation of the disclosure regime in Chapter 6D.

Objectives of deterrence do not necessitate very frequent enforcement, but do require an expectation that the laws will be sufficiently and appropriately enforced to curb the temptation by participants involved in the securities markets to engage in misconduct. A pattern of light enforcement will diminish the effectiveness of the securities laws, whether or not those laws are correctly drawn from the policy perspective. The most striking observation that comes from the analysis in this dissertation is therefore the lack of an enforcement record in Australia, both in criminal and civil actions.

While ASIC has vigorously used its stop order power over the last decade (particularly in 2000 - 2001) that does not perform as significant a deterrence function as the use of a criminal or civil sanction against a participant involved in the capital raising process who has not met the standard of conduct required by the legislation. This is because the imposition of a stop order on an offering does not have attached to it the level of public opprobrium that comes with a finding of

liability for a deficiency in disclosure against the individuals involved in the capital raising process.

From a comparative perspective, it has been suggested that the key differences between effective and ineffective corporate governance systems are either because the laws are bad or courts do not enforce those laws.<sup>1</sup> Subject to the comments made below, the Australian regime is reasonably well drawn and is consistent with the general structure of the regulatory provisions described in comparative analysis. That is a desirable feature having regard to the ongoing globalisation of securities markets.

However, what is stark is the contrast between the Australian enforcement record and that of the United States. Australia's experience in that regard is consistent with other comparable jurisdictions. While the ongoing debate in the United States as to the social desirability of the private securities litigation explosion in that jurisdiction suggests that a slavish adherence to the view that American is better is undesirable, the reverse situation in Australia is a cause for policy concern.

As has been discussed, the remedy in section 11 of the *Securities Act* lay dormant for 35 years until the "wall street bombshell" of the *BarChris Case*.<sup>2</sup> The issue is whether Australia is similarly awaiting the wake-up call of such a case or whether there are other factors that would prevent that happening in Australia .

At one level, these concerns apply with equal force to the Australian securities laws generally where the enforcement record is patchy at best. This dissertation has sought to test the generality of that concern by reference to the specific sanctions in the prospectus context. Clearly the analysis suggests an ongoing general policy difficulty that should be reflected upon.

Analysis of the criminal sanction has demonstrated that, despite a professed desire to enhance investor protection, the current criminal sanction imposes higher hurdles on a prosecution than that that existed prior to the enactment of the *Corporations Law*. The failed prosecutions of the early 1990s based on the preceding legislation (irrespective of views that might be held of the merits of these cases) should have raised the question of how to make the criminal sanction more relevant.

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<sup>1</sup> See for example A. Schleifer & R. Vishny "A Survey of Corporate Governance" (1997) 52 *Jnl of Fin* 737 at 740.

<sup>2</sup> See text accompanying footnote 124 of Chapter 1 and 115 to 121 of Chapter 1 above.

The reforms of the *Corporations Law* and the *CLERP Act* involved no such inquiry at a practical level. As such, it should not be assumed that there will be any significant change in experience caused through the restated sanction, despite the renewed interest of ASIC in pursuing these remedies.

Of course, the relevance of the criminal sanction may change over time as a result of improved enforcement mechanisms<sup>3</sup> and developments in Australian criminal law generally. That would have been a more fertile area of focus to the changes that were made to the criminal sanction in Part 6D.3 during the 1990s.

Analysis of the civil sanction has similarly demonstrated that the reforms of the *Corporations Law* and the *CLERP Act* do not provide significant assistance to an investor in enforcing private rights against those involved in the capital raising process. As outlined in section 3.3, the continuing impact of the ambiguity of the measure of damages, failure to clearly identify who has a cause of action and uncertainty as to causation and reliance means that the practical relevance of the sanction remains open to doubt.

Once more, developments in external factors such as class actions and ASIC representative actions suggest that changes in the Australian experience may yet come.<sup>4</sup> However, at the most basic level the reform agenda analysed in this dissertation did not involve any meaningful threshold analysis of how to make the civil sanction more practically relevant.

Further work therefore needs to be done in the Australian context on these basic issues if regulators and legislators want to more seriously achieve the objective of improving the enforcement record. Again, that is a criticism that can be made more generally of Australia's securities laws. The analysis of this dissertation is an illustration of that proposition.

Notwithstanding these criticisms, there is evidence that participants in the capital raising process in Australia do heed the existence of the *Corporations Act* liability regime<sup>5</sup> and do seek to meet high standards of disclosure. One suspects that the repeat players (professional directors, underwriters and advisors) are sufficiently deterred, even with a poor enforcement record, as a result of the initiatives introduced by the *Corporations Law* in more directly imposing liability on those groups as gatekeepers.

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<sup>3</sup> Resolution of the ASIC/DPP functions discussed in Section 2.3 is a good illustration.

<sup>4</sup> See text accompanying footnotes 48-9 of Chapter 1 and 155 to 161 of Chapter 3.

<sup>5</sup> As demonstrated by the analysis in the dissertation.

The particular cause for concern are the pressures that arise for insiders with strong personal interests to seek to bend the rules where they have a strong personal interest in a particular outcome being achieved. It is particularly in this area that there is a critical need for there to be seen to be an effective enforcement record.

## 11.2 SOME CONTINUING DRAFTING DEFICIENCIES

At a more detailed level, this dissertation has identified various aspects of the liability regime where continuing structural deficiencies are likely to undermine the policy objectives of the Australian regime. It is true that the adoption of the *CLERP Act* has removed a number of important areas of concern.<sup>6</sup> However, others remain. The key areas of continuing concern identified in the analysis of this dissertation are:

- The establishment of damages under section 729 in the areas of measuring loss, identification of potential plaintiffs and principles of causation and reliance as discussed in Section 3.3. This issue has a direct bearing on the likelihood of meaningful enforcement experience so as to create effective deterrence as discussed in Section 11.1.
- The failure to more analytically assess the appropriate level of criminality for section 728 liability so as to achieve appropriate deterrence, as discussed in Section 2.3.
- The continuing application of the *Misleading & Deceptive Conduct Provisions* jurisprudence to securities transactions (outside of the overlap resolved by section 1041H(3) of the *CA*) so that a negligence standard of culpability applies to prospectus misstatement while a lower innocent misstatement standard applies to general securities misstatement as discussed in Section 5.1.
- The lack of clarity as to the obligations of disclosure that arise under the Australian regime through failure to provide any detailed disclosure guidelines in support of the general disclosure standards as discussed in Sections 6.2 and 6.3.
- The failure to explicitly address the position of senior management in the scheme of regulation as discussed in Section 7.4.

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<sup>6</sup> By way of the most notable examples, the structure of the due diligence defences (see Section 4.1) and the interaction with the *Misleading & Deceptive Conduct Provisions* (see Section 5.1).

- The ambiguity of the liability of the issuer having regard to the application of the due diligence defences to the issuer's position as discussed in Section 7.5.
- The failure to provide for a regime that recognises rights of contribution where a number of persons involved in the prospectus preparation process may have concurrent liability as discussed in Chapter 10.

Further, in a small number of areas it can be argued that the *CLERP Act* reforms reflected a step backwards in terms of appropriate policy formulation. Examples of these areas identified in the analysis of this dissertation are:

- Imposition of primary criminal liability only on the corporate issuer or seller of securities (and not, for example, its directors) as discussed in Section 2.1.
- Lack of clarity in relation to the "reasonable reliance" defence of CA section 733 and failure to appropriately deal with the traditional expertisation defence, as discussed in Section 4.1 and illustrated in Section 7.3.
- Lack of policy clarity in the imposition of liability on underwriters but not stockbrokers as discussed in Section 8.2.

A broad overarching criticism that can be made of the original enactment of the *Corporations Law*,<sup>7</sup> and to a lesser degree the *CLERP Act* changes,<sup>8</sup> is that a number of changes were made to advance political interests. This dissertation has demonstrated that many of these deficiencies should have been remedied if the law reform process had involved a more rigorous process of review of the historical development of the legislative provisions and of comparative legislation in other jurisdictions.<sup>9</sup>

For almost a century the Australian prospectus liability rules were largely static. In the course of a decade they have now been rewritten twice. On the whole the outcome is a distinct

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<sup>7</sup> Evidenced by the lack of regard to a review of existing deficiencies or public submissions, as demonstrated by the failure to have meaningful regard to the *SIRC Report*.

<sup>8</sup> Evidenced by the pursuit of the SME initiatives.

<sup>9</sup> A good case can be made that the only coherent legislative reform framework put forward in Australia was that set out in the *Corporations and Securities Industry Bill 1974*, developed through comparative analysis and a report commissioned from Professor Loss - see text accompanying footnote 191 of Chapter 1.

Beyond that, this dissertation has demonstrated that in many areas the *SIRC Report* contained sensible analysis of many of the key areas identified as deficiencies.

Unfortunately the work done in those two sets of materials would seem to have been overlooked since that time.

improvement on that which went before. However, the degree of change is extraordinary and is certainly unparalleled in any of the comparative jurisdictions reviewed for purposes of this dissertation. There is a serious concern that the price of change has been too great and insufficiently developed and considered from the policy perspective.

The key shortcomings identified in above are generally external to the formal structure of the sanctions in Part 6D.3 and are capable of being advanced without interference with that basic structure.<sup>10</sup> As such, no immediate structural changes to the legislation are necessitated.

A key lesson to be learned from the last decade in relation to prospectus liability reform is that one should hasten slowly with law reform and only after fully considering historic lessons, policy objectives and comparative analysis.

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<sup>10</sup> In the case of the disclosure regime, that criticism can be advanced without any change to the legislative structure.