CIVIL LIABILITY FOR ERRORS AND OMISSIONS IN INFORMATION MEMORANDA IN THE WHOLESALE CAPITAL MARKETS

Commentary

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INTRODUCTION

Brian Salter's paper provides a comprehensive and thought provoking discussion on the application of section 52 of the Trade Practices Act, and the corresponding section 995 of the Corporations Law, to securities distributed in the wholesale capital markets. His paper is timely, given the legislative reforms which have been recently proposed by the Corporations Law Simplification Task Force (CLSTF).[1]

In the context of share offers, the ubiquitous "misleading and deceptive conduct" prohibition provided for in section 52 was given significant publicity through the litigation arising from the NRMA prospectus. As most of you will recall, that litigation centred on the implications associated with the expression "free shares" (and confirms the old saying that there is no such thing as a "free lunch").

In order to highlight a number of the key points in Brian Salter's paper and the potential application of section 52 (or 995) to an "excluded offer" of securities, I will discuss, by way of a case study, offers of "infrastructure bonds" (IBs) to "retail" (in the sense of individual rather than corporate) investors. This approach is both consistent with the infrastructure theme for this conference and particularly topical, given the recent IB offers which have been made by Commonwealth Bank (for the M5 Western Link (NSW) and Melbourne City Link tollroad projects) and Westpac (for the Melbourne City Link toll road, Collinsville Power Station and Osborne Cogeneration projects) and the other IB offers which are expected to be marketed before 30 June this year.

To understand how an infrastructure memorandum for IBs may be misleading or deceptive, it is necessary to first consider the general nature of IBs and secondly to consider the reason why IBs are an attractive investment to individual investors with high taxable income. From that background it is then possible to examine who may be potentially liable for misleading and

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1 Report on Fundraising, Attorney-General's Department, November 1995

deceptive conduct in relation to a retail IB offer and how those people can seek to limit that exposure.

WHAT ARE INFRASTRUCTURE BONDS?

Like most financial products, IBs have no shortage of acronyms. Infrastructure borrowings[2] can take the form of a DIB,[3] an IIB[4] or a RIB,[5] each of which is a type of DAB.[6] The expression "Develop Australia Bonds" is the generic marketing expression adopted by the Development Allowance Authority (the DAA) for all types of IBs. The DAA is the body which issues infrastructure borrowing certificates, which are essential for the desired tax treatment for IBs.[7]

The precise legal structure for the various IBs which have been the subject of public offers has varied in detail, from simple promissory notes to separate "interests" in a single borrowing. For section 995 of the Corporations Law to apply, the IBs that are offered to investors must be "securities". IBs will generally be securities on the basis that they are "debentures" (being, in essence, a document which acknowledges a debt).[8] In any event, under the current law, section 52 will apply whether or not the IBs are securities and regulated by the Corporations Law.

The next question for any IB issue is whether a prospectus is required. Most retail IB issues are structured as secondary sales and not direct offers for subscription. One reason for this is that the offers are invariably "packaged" with a corresponding non-recourse loan to the investor (to enable the investor to acquire the IBs and to prepay, at least in part, interest on the loan). If the loan and the IBs were "acquired" from different entities, there is a significant risk that the package would constitute a breach of section 47(6) of the Trade Practices Act (ie, third line forcing). Accordingly, on the basis that the offer is for IBs which have already been acquired by the entity making the offer, a prospectus will only be required, if at all, if section 1030 applies (which deals with secondary sales). Given the substantial costs involved in preparing and registering a prospectus, most (if not all) retail IB offers have taken advantage of the "gold card" exemption for offers for purchase where the amount payable by each investor is at least $500,000.[9]

Some IBs issued to retail investors have been described as "bonds", which reflects the long term of most IBs (up to 15 years, the maximum term permitted by the DAA Act). Other IBs have been described as "notes", being a description which is more consistent with a debt security with a much shorter term. Most retail IB offers are structured so that, in the hands of an investor, the IBs

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2 This is the technical expression for infrastructure bonds used in Chapter 3 of the Development Allowance Authority Act 1992 (DAA Act).

3 Direct infrastructure borrowing, section 93F DAA Act.

4 Indirect infrastructure borrowing, section 93G DAA Act.

5 Refinancing infrastructure borrowing, section 93H DAA Act.

6 "Develop Australia Bonds" - see the Information Kit supplied by the DAA on request.

7 Ie, exempt interest income for individual taxpayers. See Division 16L of the Income Tax Assessment Act 1936 (Cth), especially section 159GZZZZE.

8 Some IBs have been issued as registered "paperless" securities and therefore no "document" for each IB is actually issued. Perhaps in these cases the deed poll which is executed by the IB issuer in respect of all the IBs constitutes the relevant document. In this context it is interesting to note that the CLSTF has proposed that the definition of "debentures" be amended to refer to the relevant "legal right" and not to a particular type of document. See also section 78(4) of the Corporations Law.

9 Section 66(3)(ba). Query whether the exemption is intended to apply where the investor receives a non-recourse loan for the full subscription price? The better view seems to be that if the minimum purchase price for the IBs on offer is at least $500,000, then the offer will be an excluded offer and no prospectus is required.

can be treated as a one year investment (either through the use of put options or some other similar sale arrangements).

IBs are targeted at individual high marginal tax payers who can negatively gear their investment.[10] To derive the maximum tax benefit, and with minimum purchase amounts starting from $500,000, the investor group for retail IB offers has been, to date, individuals with taxable incomes in excess of $100,000.

WHO COULD BE LIABLE UNDER SECTIONS 52/995?

In any action taken by an investor for misleading or deceptive conduct in relation to an IB retail offer, there are a number of potential defendants.

In the front line is the sponsor (sometimes referred to as the "underwriter"). Unlike certain other offers in the capital markets, the sponsor is generally responsible for the preparation and distribution of the information memorandum and no dealer panel is involved. Directors and other people associated with the sponsor and the information memorandum may also be liable.[11]

Given the significance of the tax treatment for a retail IB offer, copies of tax opinions from either accountants or solicitors are often included in the information memorandum. Those professional advisers could be liable for misleading and deceptive conduct in relation to their opinions.

The participation of the project company in the underlying infrastructure project is essential for any IB. Without the qualifying infrastructure project, no IB offer can proceed. An investor may seek to join the project company in an action taken against the sponsor on the basis that the project company was somehow "involved" in the relevant misleading or deceptive conduct. However, most retail IB offers are structured without the express involvement of the project company. For some IB offers, the information memorandum expressly states that the project company had no involvement in the preparation of, and is not liable for anything contained in, the document. In these circumstances, it is unlikely that an investor will be successful in an action against the project company.

Finally, it is quite common for sponsors to arrange for a special purpose company to be the actual "issuer" of the IBs (most commonly, IIBs). While that company could also be joined in an action against the sponsor, it is often not a company of substance and unlikely to provide the investor with any substantial satisfaction.

HOW COULD THEY BE LIABLE?

As Brian Salter points out, the section 52 cases have established that the "reasonable expectation" test sets the standard for disclosure in an information memorandum. Also, the relevant misstatement or omission must be material.

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10 IBs have also been acquired by institutions (particularly super funds) which can obtain the benefit of a 36% tax rebate, while accruing interest income on the IBs and paying tax at a concessional rate (usually 15%).

11 As summarised and analysed in the paragraphs under the headings "Engaged in a Contravention", "Involved in a Contravention" and "The Possible Extended Scope of Section 1006" of Brian Salter's paper.

What then is the "reasonable expectation" of retail IB investors in terms of what should be disclosed to them in an information memorandum? Again, as Brian Salter points out, there are two views as to the purpose of an information memorandum in relation to an exempt offer. Either:

1. The information that is expected to be disclosed is similar to the standard set out in section 1022 of the Corporations Law - all information that the investor would reasonably require and reasonably expect for the purposes of making an informed assessment of the investment.

2. There is a duty on prospective investors to satisfy themselves about the IBs and that the sponsor cannot be expected to predict all the information that would be relevant to investors.

Because of the uncertainty as to which of these two alternatives will be adopted by the courts, there is a natural inclination for sponsors to include more information than less and to engage in varying degrees of due diligence. The real concern about section 52 is that a contravention may occur without knowledge or fault on the part of the sponsor and notwithstanding the exercise of reasonable care.[12] The irony for a sponsor of an exempt offer is that even if they adopt the higher "prospectus" standard of disclosure they do not enjoy the corresponding Corporations Law defences, including the due diligence defence under section 1011.

In the context of IB investments by individuals, most of the offers are on a packaged non-recourse loan basis, so that investors do not take any project risk. Accordingly, the creditworthiness and repayment ability of the issuer is irrelevant to the investor. For this reason, no details about the project cash flows and repayment prospects for the IBs should reasonably be expected by investors. The key issues for an investor are that:

(a) The relevant IBs have the benefit of a DAA certificate and therefore qualify for the appropriate tax treatment.

(b) The investor will be able to negatively gear and obtain the full benefit of the interest and fee expenses associated with the borrowing incurred to acquire the IBs.[13]

The tax issues are of primary importance.[14] In this context, the sponsor of the investment opportunity will need to clearly identify the risks and the nature of any tax rulings or opinions. For this reason, as noted above, sponsors have often included the full text of relevant tax opinions in the information memorandum.

HOW TO AVOID OR LIMIT LIABILITY?

The simple answer is to ensure that there is nothing "misleading or deceptive" in (or omitted from) the information memorandum. In addition, sponsors can include an appropriate disclaimer, while others involved in the issue of an information memorandum can seek to obtain indemnities from the sponsor.

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12 See *Fraser v NRMA Holdings* (1995) 127 ALR 543 at 556.

13 See Taxation Determination TD 94/80.

14 The tax sensitivity of IBs was highlighted by the Treasurer's Press Release on 30 October 1995 relating to "tax aggressive" IB structures. To date no draft legislation has been tabled to implement the measures announced in that Press Release.

It is almost invariable that sponsors will include a disclaimer in the information memorandum.[15] Brian Salter has summarised the extent of the legal protection afforded by a disclaimer in these terms:

> "It is likely that the courts would be more prepared to uphold such a disclaimer where the recipient, as with a capital markets issue, is sophisticated. However, it is equally likely that a court's approach would also be influenced by its assessment of how practical it would have been for an investor to rely on its own inquires."

In the context of IBs, it is certainly true that the investor group have financial resources but is by no means certain that they are sophisticated. The investor group is likely to include people who are less intelligent or less well informed than the average member of the community. Equally, it is not apparent that investors would be able to easily confirm that the details of the IBs have complied with the DAA Act requirements or that the appropriate tax treatment will apply.

Clearly, disclaimers are directed at negating reliance, one of the essential elements in any section 52/995 claim. Invariably investors are instructed by the disclaimer to seek their own tax and financial advice. Investor are probably more likely to be able to verify the tax treatment for the IBs than whether or not the DAA Act requirements have been satisfied. On this basis, the disclaimer is more likely to be held as an effective shield in the tax context than in relation to DAA compliance.

While there remains a degree of uncertainty as to the effectiveness of disclaimers, their potential usefulness cannot be ignored. However, sponsors should view a disclaimer as providing additional protection rather than a complete excuse for exercising proper care and diligence. The primary objective should be to ensure that the information contained in the information memorandum is clear and accurate and that there are no material omissions.

Another area where potential defendants might seek protection is through an express indemnity. I am aware of circumstances in which a project company obtained an express indemnity from the sponsor for any liability in relation to an IB information memorandum. Needless to say, enthusiasm among banks and other sponsors for such indemnities is particularly limited.

CONCLUSION

Clearly the potential liability under section 52 and 995 cannot be ignored by any one involved in preparing an information memorandum. Until the law is changed, the risk of a section 52 action will always be present, as highlighted by the *NRMA* case. It remains to be seen whether the policy issues and proposed reforms identified by Brian Salter and the Corporations Law Simplification Task Force are adopted. As Brian Salter says:

> "It is hard to escape the conclusion that if sections 52 and 995 are inappropriate for the public equity markets, because they disturb the balance between the interests of investors and issuers, and so impede the raising of capital, then this must also be the case for the capital markets."

Only time will tell whether this conclusion will prevail in relation to dealing in securities. My own sense is that section 52 has assumed a degree of universal application that there will be significant reluctance to remove its application in particular areas. If my prediction is right, then perhaps the alternative legislative response should be to provide those people involved in excluded offers, like retail IB offers, with the benefit of the same defences which are available in relation to a registered prospectus.

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15 For example, in a recent information memorandum the disclaimer stated that: "Any purchase of the investments should be based solely on your own investigations and your independent taxation, legal and/or financial advice as you see fit".