Due Diligence Associated with Prospectuses for the Offering of Securities: Commentary

John Harry and Ian Renard***

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* LL.B., LL.M. (Virg.), Solicitor, Melbourne.

** B.A., LL.B., Solicitor, Melbourne. The authors wish to acknowledge the great assistance of our associate, Peter Gray, in the preparation of this commentary.

INTRODUCTION: DESCRIBING DUE DILIGENCE

Robert Nicholson has provided a comprehensive and informed description of the key elements of the due diligence systems which are currently used for major share issues. He has also described the evolution of the legal principles which govern disclosure of information in a prospectus. This is an unenviable task, for due diligence in practice may not accord perfectly with due diligence in theory. The reason is that this area of law is full of problems: the prospectus provisions of the Corporations Law are new and no case law exists to explain them; the provisions themselves are drafted widely with a complex matrix of defences which may provide inadequate protection, on a technical construction of the liability provisions, to some due diligence participants; the relevant theory imported from other bodies of law and other jurisdictions has been only sporadically applied; and no consensus in either the securities market or the legal profession has yet developed on important questions relating to the required information content of a prospectus and the legal duties of the various parties involved in its preparation under the new provisions.

The due diligence process has therefore developed since January 1991 on a somewhat shifting theoretical base and has moved in unexpected and contradictory directions. This presents lawyers advising on due diligence processes with various difficulties. Nicholson's paper raises and describes these theoretical and practical problems confronting resources companies which seek to comply with the prospectus provisions.

THE MARKET INFORMATION PRINCIPLE

The prospectus provisions are not the only disclosure requirements a listed company faces in respect of its securities. At the same time a range of separate regulatory provisions may apply: the Australian Stock Exchange disclosure requirements, and particularly continuous disclosure rule 3A(1), are a constant cause for concern; s. 995 of the Corporations Law may be triggered by a failure of an issuer to keep the market informed, according to the ASC;[1] involvement in insider trading is also a concern because of the expansive nature of the insider trading liability provisions (if those provisions are construed literally), and disclosure to a prospective purchaser will commonly be the only means available to a corporation for avoiding liability. All these areas of market information regulation have been subject to recent reform measures.[2] As a result, these areas of regulation are current causes of uncertainty in the securities market. More uncertainty derives from the fact that the prescribed levels of disclosure vary from one head of regulation to the

1. ASC Practice Note 12, 30 July 1991.
2. Listing Rule 3A(1) is the most recently amended disclosure requirement, by the addition of para. (c)—a disclosure requirement modelled on the provision of the Corporations Law which prescribes the information content of a prospectus required to be lodged under Pt 7.12 of the Law, s. 1022.

other, the fact that regulatory powers are currently divided between the Stock Exchange and the ASC, and the unco-ordinated approach presently taken to law reform and regulatory reform relating to disclosure.[3] The prospectus provisions themselves contain various inconsistencies and ambiguities, some of which are discussed below.

Recent reforms are a response to what has been perceived as corporate immorality. Although reform to these areas of securities regulation has been conducted on an apparently unco-ordinated basis, the trend evidenced across each of these areas is a common theme: enhancement of the responsibility of issuers and vendors to provide information to the market. The government demand for greater disclosure arose from awareness of practices in the securities industry of the 1980s brought to public attention by a long series of spectacular corporate scandals. Likewise the key United States securities legislation was put in place in the early 1930s because the practices of America's securities industry had become infamous at that time.

The new trend in thought is that the market has a right to be better informed, and recent reforms contain some extravagant measures to achieve this. The prospectus provisions are one such measure. It is reasonable for the legislature to demand that capital be raised in ways which protect investors, for the share is an item of property whose true nature and value is not easily ascertainable and one which would, obviously, be susceptible to abuse by issuers if issuers were not bound to disclose to securities investors information relevant to the likelihood of a return on investments. On the other hand, that demand has to be tempered by the need to permit capital to be raised at a realistic cost. It is possible to have too much disclosure: if the costs of disclosure are to rival the benefits of securities issues, alternative means of fund raising will be sought.[4]

A NEW NORM FOR DISCLOSURE IN A PROSPECTUS: SECTION 1022

Section 1022 of the Corporations Law represents a change from the prescribed "checklist" approach of the Companies Code to a "general disclosure obligation".[5] The preparers of a prospectus must take the initiative under s. 1022 in determining what information is required by investors for the purpose of assessing the "prospects" of the issuing corporation. It was the legislature's hope that this would prompt the disclosure of more relevant information than investors were receiving under the Code system.[6] The prospectus preparers are provided only

3. The Stock Exchange currently regulates continuous disclosure, although a Bill for a statutory regime has been promised for August 1992 by the Attorney-General: Report of the Prospectus Law Reform Sub-Committee of the Companies and Securities Advisory Committee, March 1992 (hereafter called the "Lonergan Report"), p. 23.
4. It is feared that smaller companies are more frequently raising equity overseas: *Business Review Weekly*, 28 February 1992.
5. ASC Policy Statement 18, 16 March 1992.
6. Corporations Bill Explanatory Memorandum, May 1988, paras 3028, 3033.

with general guidance as to the considerations which are to be taken into account in deciding what information would be so required by investors and how much of that information is reasonably obtainable by, or known to, the preparers.[7]

Exactly what specific data will be required in a given case is left to be determined by the preparers, and it is here that uncertainty has resulted. The lack of guidance as to what is required to be disclosed by due diligence in turn leads to uncertainty as to how the due diligence system should be structured.

The history of prospectuses issued since January 1991 reflects this uncertainty. There was initial concern that the new prospectus regime required a prospective issuer to go to all possible lengths to assess the information needs of the market, including the use of survey questionnaires directed at market analysts (as occurred prior to the Commonwealth Bank float) and asking what potential subscribers would wish to have disclosed. It does not appear that recent issuers have gone to such lengths to identify the requirements of s. 1022. Instead, content standards seem to vary from prospectus to prospectus. The Lonergan Committee noted this lack of consistency between prospectuses as a cause for concern, because presumably it hampers the analysis of prospectuses by investors and advisers and detracts from the easy dissemination of prospectus information.[8]

In spite of the emphasis on "prospects" in s. 1022, forecasts and business strategy statements are not always to be found in prospectuses. The Commonwealth Bank prospectus of July 1991 was criticised for the absence of forecasts.[9] But the reluctance of issuers to provide information the accuracy of which is contingent on market conditions is understandable, particularly given the danger that a forecast will be found to be "misleading" on the stringent test of reasonableness of statements made in respect of future matters provided for in s. 765 of the Corporations Law, and the possibility that a supplementary prospectus will have to be issued (as was the case in the National Foods float, only one month after the primary prospectus was issued) if the issuer becomes aware of new information which affects the validity of the forecast.[10]

COMPARATIVE LAW AND PRACTICE

In the absence of local judicial guidance on how best to respond to the requirements of s. 1022, attention has been directed to the due diligence process in the United Kingdom, the United States and Canada. All three jurisdictions have prospectus disclosure requirements similar to those of s. 1022. The relevant United Kingdom provision—s. 163 of the *Financial Services Act* 1986—provided the legislative model for s. 1022.[11] The United States and Canadian (Ontario) provisions require

7. Section 1022(3).
8. Lonergan Report, p. 27.
9. Lonergan Report, p. 33.
10. See s. 1024.
11. Lonergan Report, p. 25.

the inclusion in a prospectus of all material facts the existence and accuracy of which are discoverable by "reasonable investigation".[12]

The United Kingdom courts have given no direct guidance on the requirements of s. 163, and the practice has been for the issuer to undertake the verification of information to be included in the prospectus. The role of the underwriter in the preparation of the prospectus is that of an observer.

This is in marked contrast to the practice in the United States and Canada, where judicial pronouncements have fixed a positive duty of investigation on the underwriter and its counsel. As a result of *Escott v. BarChris Construction Corp.*[13] and *Feit v. Leasco Data Processing Equipment Corp.*,[14] an underwriter "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." The situation is the same in Canada as a result of *A. E. Ames & Co. Ltd.*[15]

THE ROLES OF DUE DILIGENCE PARTICIPANTS

Theory

The stringent duty of investigation placed on underwriters in the United States and Canada should, as a matter of logic, apply in Australia. Under the Corporations Law, underwriters are allowed a defence in respect of a defective prospectus where the defect was caused by reliance on, or the default of, a third party only if the underwriters' reliance was "reasonable" or they exercised "due diligence" and took "reasonable precautions" to ensure the prospectus was not defective. Admittedly, the ability of underwriters to "descope" or confine their area of responsibility in the prospectus (and therefore their exposure of potential liability) under s. 1010 is a departure from the principles applying in North America, but otherwise the requirements of reasonable investigation which apply to underwriters under the Corporations Law are apparently identical to those observed in practice in North America.

The matrix of defences for the corporation, its directors and "promoters"[16] in the preparation of a prospectus likewise requires reasonable precautions if reliance is to be placed on the statements of others.[17] Thus the theoretical interpretation of the prospectus provisions of the Corporations Law is that a high degree of independent cross-verification is required in the due diligence process.

12. Section 11 of the *Securities Act* 1933 (U.S.); s. 126 of the *Securities Act* 1970 (Ontario).
13. 283 F. Supp. 643 (1968).
14. 332 F. Supp. 544 (1971).
15. (1972) 18 O.S.C.B. 98.
16. No definition is provided in the Corporations Law.
17. Section 1008A(2)(d): directors must hold a reasonable belief in the competence of experts where reliance is placed on statements of experts; s. 1011: the corporation, its promoters, and persons authorising or causing the issue of the prospectus must exercise due diligence if they are to escape liability for defects caused by the defaults of others.

As between the key players, the ideal is greater independence: independence of the underwriters vis-à-vis the company and, therefore, independence of the lawyers (on whom the underwriter must rely) overseeing the due diligence process vis-à-vis the company. The benefits of this independence would be:

(a) relief from the dangers of conflict of interests on the part of the lawyers, because the lawyers would no longer be the usual counsel of the company and therefore could be under no pressure to limit their investigations of the company's financial position and prospects; and

(b) that the underwriters would no longer be "captive" to the company: the underwriters would not be relying on the statements of due diligence investigators who may have been under the kind of pressure mentioned in (a).

Practice

However, the prospectuses issued under the Corporations Law since January 1991 exhibit confusion on the issue of the place of the lawyer overseeing the due diligence process. In particular, the level to which the underwriter should be using the underwriter's counsel to investigate the process is unclear. The National Australia Bank prospectus was issued in the initial phase of uncertainty regarding the requirements of the new Corporations Law.[18] It involved a due diligence process that was close to a United States-style, independently investigated and verified due diligence. Since the NAB prospectus, the independent role of the underwriter has been gradually eroded: in the Commonwealth Bank float[19] the role of the underwriters was that of an active auditor. As far as we are aware, the common practice so far this year has been not to involve underwriters' own counsel directly in the due diligence process and instead to rely on the issuer's usual lawyers.

Although it is impossible to generalise with accuracy, it appears that current practice is now approaching the United Kingdom-style verification process, and the underwriter's role is sometimes that of an observer rather than an active participant. More recently, a practice has evolved whereby the issuer will retain a financial adviser to make the decisions as to what information is required by s. 1022, and the financial adviser will report to the issuer's usual counsel, who will act as the lawyers overseeing the due diligence process. The underwriters are then asked to accept the results of this issuer-driven process, but are relieved from giving a s. 1022 certificate. The danger of this practice is that, if the Australian courts should adopt the North American approach to interpretation of the prospectus provisions and require underwriters to adopt an active and independent role in prospectus preparation, an issuer-driven due diligence process may not provide the underwriters with a defence in an action based on a defective prospectus.

18. 28 February 1991.
19. 5 July 1991.

Underwriters' fees should rise to take account of the risk factor inherent in accepting the results of a due diligence process entirely undertaken by the issuer's advisers but there is little to suggest that this is happening.

A crucial question in each issue is who advises the directors of the issuer as to what areas need to be addressed in the prospectus to satisfy s. 1022. It is risky for an underwriter to give a certificate stating that s. 1022 has been complied with if the underwriter is relying exclusively on the issuer's lawyers.

The allocation of official positions in the process, such as the choice of chair of the due diligence committee, will depend on the abilities of the individuals available in a given case, and the chair's role is not restricted to any particular class of person (accountants, directors, lawyers, etc.). However, in many cases the lawyer for the issuer emerges as a de facto co-ordinator as the due diligence progresses. Executive directors and management also have a significant ability to direct the process of business risk identification, because it is only management who possess knowledge of the details of a company's business strategy and the problems and risks encountered and likely to be encountered in pursuing that strategy. This is particularly true of smaller companies. With the substitution of the Code's statutory checklist for the Corporations Law's non-prescriptive general disclosure obligation, the risk identification process has probably become more dependent on management, because the prospectus preparers must take the initiative in determining the path of investigation.[20]

Cutting corners

It seems the strict logic of the North American "independent investigation" approach is irresistible. But this approach has not been adopted. It is easy to see why: in most cases an independent investigation co-ordinated by the underwriter's lawyers will involve a duplication of effort and therefore of expense. Australian law is not clear on the question of who is required to oversee due diligence, but logic and North American authority suggest that the underwriters should generally oversee the process. Moreover, there is no theoretical justification for taking the easier option of relying on the issuer and its usual or in-house counsel to oversee the process if reasonable avenues of independent inquiry are available.

Nicholson demonstrates the inconsistencies between the theory and practice by approving certain of the North American principles of "independent investigation"[21] and acknowledging that "it would be

20. It is here that the checklist approach, for example that advocated by the SIA's "yellow book", is of continuing utility: it encourages management to consider areas of the company's activity to which management might be unwilling to draw attention.
21. R. Nicholson, "Due Diligence Associated with Prospectuses for the Offering of Securities", above at 319: "management should not determine any of the areas of investigation . . . the investigations themselves must be made by persons independent of the company."

dangerous for those 'external' to the company simply to accept the advice of management as to the areas of greatest risk to the company,"[22] at the same time as observing that "in most cases, the bulk of the due diligence responsibilities have fallen on the company's auditors and legal advisers."[23]

The underwriters would therefore be well advised to exercise caution and be conscious of the "independent investigation" approach in respect of the lawyer's roles as both overseer and adviser providing specialised knowledge in respect of the company's liabilities. It is not necessarily correct to say that in every case "it matters not which of the firms involved in the process assumes primary responsibility for legal due diligence.[24] There is a policy question to be addressed: "To what extent should the company making the issue be allowed to drive the due diligence process?" The answer to this must reflect a balance between the necessity for economy (the downside of which is that the company must be relied upon) and the independence of the process (the downside of which is expense).

The extent to which underwriters may reasonably depend, at least in part, on the investigations and report of the issuer's lawyers will depend in each case on a number of factors including:

(a) the standing, reputation and ability of the issuers' lawyers;

(b) the extent to which, during the process, the underwriters can see that those lawyers are in fact free of pressure from their client in deciding what questions may be asked, what areas of possible risk can be investigated and what may be disclosed in the prospectus;

(c) the extent to which the underwriters use their own lawyers to examine critically the system being used by the due diligence committee; and

(d) the apparent quality of the final due diligence report of the issuer's lawyers.

In our view, the recent tendency of some underwriters to use their counsel simply to draft the underwriting agreement and to act as a sounding board when tough issues arise exposes the underwriters to unnecessary risk. For competitive reasons, underwriters are disinclined to include more than a modest fee for their own counsel when quoting for a prospective underwriting. While this may be understandable, we wonder whether the directors of the underwriters fully appreciate the true level of risk they are undertaking.

Role of the lawyers

An equally important question is, "Are lawyers, whether they be the advisers of the issuer or the underwriter, suited to the task of overseeing the due diligence process?" A careful distinction needs to be made

22. Nicholson, above, p. 327.
23. Nicholson, above, p. 330.
24. Cf. Nicholson, above, p. 334.

between interpreting the requirements of the Corporations Law in a general sense and applying the prospectus provisions in a particular case. The fact that s. 1022 is cast in terms of the information requirements of the market means that lawyers will be unsuited to the task of directing the due diligence process toward business risk areas in a given case. Compliance with the Corporations Law is not merely a legal question, so the role of lawyers as co-ordinators should perhaps be restricted accordingly.[25] There may be scope here for the creation of a new role in the due diligence process for an independent person skilled in identifying business risk factors: a "risk assessor". Perhaps an accountant or market analyst employed by the underwriter would be an appropriate candidate for this position.

Also problematic is the issue of liability for part involvement in the preparation of a prospectus, and whether lawyers only peripherally involved in an issue should elect to be named in the prospectus so as to take advantage of the "advisers" defences.[26] The short answer to this is that if lawyers are not "involved" in the issue of the prospectus within the meaning of s. 79 of the Corporations Law, there is no reason for them to elect to be named. However, as "involvement" is defined very widely under s. 79,[27] it may be preferable for lawyers to elect to be named, and then to take advantage of the "descoping" defence under s. 1010.

THE DUE DILIGENCE SYSTEM

The ideal

The ideal due diligence process would involve a comprehensive preparatory survey of market information needs; would be conducted consistently with the principles of independent investigation observed in North America; and would involve the widest possible scope of inquiries and the most thorough analysis of risk areas, regardless of costs and practicability. This may be what is required for technical compliance with the prospectus provisions of the Corporations Law, but it would be an impractical interpretation of the provisions for a court to adopt.

Practicability

For example, Nicholson notes the importance of establishing a chain of reports and documentation from all persons "with direct knowledge

25. Cf. Nicholson, above, p. 334. Lawyers would seem to be generally unqualified to provide specific assurances that clients will be able to avail themselves of the defences provided for in the Corporations Law, although Nicholson suggests that such a statement might be given in some circumstances, above, p. 339.
26. The Lonergan Committee commented on the problem of differently worded defences for people involved to different levels in prospectus preparation, and recommended that a s. 1011-type defence should apply to all parties who may incur liability in respect of a defective prospectus: Lonergan Report, op. cit. at 73.
27. Liability may attach to anyone who, inter alia, "has been in any way, by act or omission, directly or indirectly, knowingly concerned in, or party to, the contravention".

of significant aspects of the company's affairs", linking such persons with the due diligence process.[28] This is a worthy ideal, but the implementation of such a system will be difficult in the case of a company with numerous subsidiaries.

How far will the courts mitigate the responsibility to investors by reference to expense and impracticability? What are going to be the methods of cost containment and of limiting the due diligence procedure that will be acceptable to the courts?

It is possible to predict some of the principles that a court might adopt in view of the change to a self-regulatory general disclosure obligation which occurred in January 1991. Materiality thresholds based on percentage of capitalisation will have to be used with great care: the prospectus requirements are that information as to the company's prospects (and therefore business risk factors) must be provided: "prospects" may be affected by factors which are not necessarily quantifiable, and the probability of a risk developing into a liability is difficult to account for if a materiality threshold approach is adopted. It may be that a seemingly insignificant risk is ignored because the level of the company's apparent contingent liability in respect of the risk technically falls outside the materiality threshold set by the due diligence committee, but in fact that risk holds potential liabilities far in excess of the current contingent liability provision. Rigid adherence to a checklist is inadvisable under the Corporations Law's prospectus requirements. The requirements are for care to be put first into the structure of the process: if the structure is good, presumably the contents of the prospectus will also be good. Nicholson advocates this kind of "organic" approach to formulating the ultimate information content of the prospectus.[29]

Constructing the system

The substitution of the Code's pre-vetting procedure for self-regulation under the Corporations Law has significant benefits in government administrative costs, and time, saved. But the cost of the new prospectus regime to the issuer is high. The Lonergan Report gives a clear indication of the Companies and Securities Advisory Committee's opinion on this point: due diligence should put the relevance of information retrieved and the identification of risk areas ahead of costs.[30]

But how do lawyers justify the costs of the new due diligence process to their clients? Obviously they are employed to protect their clients from incurring liability under the Corporations Law. It is as well to remember, however, that due diligence is a construct of the legal profession, as yet untested by Australian courts in the securities context,

28. Nicholson, above, p. 339.
29. This emphasis on "system" is suggested by cases such as *Universal Telecasters Queensland Ltd v. Guthrie* (1978) 32 F.L.R. 360 on *Trade Practices Act* 1974 (Cth), s. 85(1).
30. Lonergan Report, p. 76.

and built on a loose analogy with trade practices case law. The title "due diligence" itself is an indication that prospectus preparation is conducted by persons whose primary concern is the avoidance of liability: the due diligence process is intended to be structured around the complex matrix of defence provisions already ably described by Peter Hopkins and Robert Nicholson.[31] Do the due diligence methods currently adopted in fact provide defences for all potential liabilities to persons involved in the preparation of a prospectus?

Trade practices case law

Jurisprudence on s. 85 of the *Trade Practices Act* 1974 (Cth) will be of assistance in construing s. 1011 of the Law, because s. 1011 was modelled on s. 85. The leading case on "reasonable precautions and due diligence" is *Universal Telecasters v. Guthrie*.[32] Bowen C.J. emphasised that the court will have regard to whether the defendant established a proper system and provided reasonable supervision to ensure the system was carried out, in determining whether the defence has been made out.[33] The system must have been structured so as to constitute "reasonable precautions" to avoid the relevant contravention, and this means the defendant must have turned its mind to the danger of the relevant contravention.[34] In the prospectus context, this means that the corporation, its promoter and underwriter must construct a system which is reasonably likely to detect information required by investors or "expected" by investors[35] in order to attract the s. 1011 defence. Trade practices cases agree with North American authority that the term "reasonable precautions" connotes a degree of independent investigation by defendants seeking the defence.[36] As suggested,[37] the allocation of roles in current due diligence processes may not satisfy this proviso to the availability of the s. 1011 defence.

Non-uniform defence provisions

Another uncertainty as to how best to structure the due diligence process results from the fact that different defences are available to participants in the process depending on the characterisation of their respective roles.

Although the Explanatory Memorandum to the Corporations Law envisaged a general defence of "due diligence" based on s. 1011 for all persons involved in prospectus preparation,[38] it is clear that no one blanket defence applies. The Lonergan Committee has recommended the inclusion of such a general defence,[39] but for the present, the nature of

31. P. Hopkins, "Prospectus for a Resource Venture" [1992] *AMPLA Yearbook*; Nicholson, above.
32. (1978) 32 F.L.R. 360.
33. (1978) 32 F.L.R. 360 at 363.
34. *Adams v. Eta Foods Ltd* (1987) 19 F.C.R. 93.
35. Section 1022.
36. *Wilkinson v. Katies Fashions (Aust.) Pty Ltd* (1986) 11 F.C.R. 390.
37. See above.
38. Paragraph 2996.
39. Lonergan Report, p. 73.

each defendant's defence will depend on the defendant's role in prospectus preparation.[40] The due diligence process is intended to enable all potential defendants to establish their respective defences, but there is uncertainty concerning the level of independence from the issuer each participant must attain if he or she is to attract the due diligence defence which corresponds to his role. This is particularly true of the underwriters.[41] This uncertainty causes difficulties when it comes to constructing the due diligence process.

Uncertain scope of liability provisions

The list contained in s. 1006 of the Corporations Law and the s. 79 definition of persons "involved" in contraventions operate to extend potential prospectus liability to a significantly larger field of players than was the case under the Code's prospectus provisions.

The expansion of the number of potential defendants to whom liability may attach since the enactment of the Corporations Law, and the requirement that reliance by, among others, an underwriter on the statements of others within the due diligence process must be "reasonable" reliance[42] has caused the due diligence process, and particularly the "independent verification" aspect of due diligence, to become more onerous since January 1991. The costs of issuing have, it is widely agreed, risen very substantially to accommodate due diligence under the Corporations Law, although according to the Lonergan Report there is only "anecdotal" evidence to support this observation.[43]

Lawyers must exercise care in structuring the due diligence process to attempt to cover this complex range of liabilities and defences. Lawyers should also remember that liability can attach to them in three ways: in their capacity as "experts" offering primary opinions on the liabilities and legal positions of issuing companies; in their capacity as "advisers" involved in prospectus preparation; and—under the general duty of care owed to clients—in their capacity as counsel to a party who incurs liability as a result of bad advice.

Of course, it is not necessary or possible that the due diligence process should provide a defence to all aspects of every provision of the Corporations Law which may be relevant to prospectus preparation. For example, misleading or deceptive conduct in relation to "any prospectus issued" (giving rise to liability under s. 995) may occur in a wider variety of fact situations than merely those situations in which liability arises in respect of misstatements in, or omissions from, the prospectus (for which situations defences may be available under the prospectus provisions). But insofar as liability may arise from a defect in a prospectus the due diligence system must provide a defence.

40. Section 1005 confers the right to recover loss by action against any person involved in the contravention of Pts 7.11 or 7.12. The "due diligence" defence however is only available to the corporation or vendor, promoters, stockbrokers, sharebrokers and underwriters named in the prospectus and any other person who authorised or caused the issue of the prospectus: s. 1011(1).
41. See discussion above.
42. E.g. s. 1011(1)(b).
43. Lonergan Report, p. 75.

The aim of due diligence should be to provide evidence to the court, in the event of investor dissatisfaction with the information in the prospectus, that all parties involved in prospectus preparation exercised the standard of care reasonably required in the contexts of their respective responsibilities, (that is, to the standard expected by the market), and are entitled to protection from liability. There are various anomalies and ambiguities in the prospectus provisions, however, which cast doubt on whether a due diligence system structured on this premise provides adequate protection to all potential defendants. The following is a list of some of these ambiguities:

(a) Section 995 extends liability for misleading and deceptive conduct in relation to, inter alia, prospectuses which do not need to be lodged with the ASC under Pt 7.12 of the Corporations Law and which therefore are not required to comply with s. 1022. A particularly difficult question is, "What omissions will constitute misleading conduct in relation to such a prospectus?" The courts must take into account that, since there are no express content requirements for a prospectus which does not need to be lodged, the question of what defects in the prospects are "misleading" in the circumstances will differ between the case of a Pt 7.12 prospectus and the case of an excluded offer prospectus.

(b) The ASC has suggested that s. 1022 is a useful guide to what is "material" for the purposes of s. 996,[44] but the Lonergan Committee thought the ASC was wrong on this point.[45] If s. 1022 is not the determinant of "materiality", what is?

(c) It is not clear how far the definition of a "person who authorizes or causes the issue of a prospectus" in contravention of s. 996 extends: are advisers and possibly even clerical staff lodging prospectuses to be caught by this provision and attract criminal liability? Although s. 996(2) provides a defence to prosecution, there is no defence to civil liability except those defences provided in the prospectus provisions on the basis of the defendant's role in the prospectus preparation. There is a danger that an adviser's potential liability as a person authorising or causing the issue of a prospectus in contravention of s. 996 or as a person involved in such contravention under s. 79 might extend to fact situations in which the defences provided for advisers in the prospectus provisions are inadequate.

(d) This last point relating to the dangers of inadequate defences for a person caught up in s. 79 liability would be accentuated if the prospectus provision defences were not available to that person at all, for example because he or she was an adviser not named in the prospectus under s. 1006, but if at the same time that person was held to be "involved" in the issue of a prospectus contrary to s. 996. Such a person would not have a defence at all. Officers of the issuer might fall within this category. The s. 1011 defence is only available

44. ASC Practice Note 12, 30 July 1991.
45. Lonergan Report, p. 93.

to a person "authorising or causing the issue of a prospectus", not to a person merely "involved".

(e) There may be a danger for lawyers overseeing the due diligence process of overstepping the "advisory" role and making "expert" contributions to the investigation. All experts and advisers must exercise care not to make comments outside their respective fields of expertise, lest they lose their due diligence defence by not being judged "competent" to make the statement.[46] The concept of "omission of a material matter (for which) an adviser is responsible" is difficult.[47] Advisers must be careful to delineate their areas of responsibility clearly so as to evidence the due diligence committee's acceptance of their "competence" and also to avoid difficulty in determining responsibility for omissions. Omissions in general are difficult for underwriters as well as advisers because the application of the "part only" s. 1010 defence requires the resolution of the question, "from what part of the prospectus has the relevant information been omitted"?

(f) The key defence provision for the underwriter and the issuer, s. 1011, is defective because these potential defendants cannot rely on the statements of "another person", no matter what precautions they take and due diligence they exercise, if that third party was, inter alia, an "agent" of the defendant.

(g) The recurring proviso to the defences of most participants in prospectus preparation—reasonable precautions or inquiries leading to reasonable belief in the accuracy or comprehensiveness of statements—is inherently uncertain. Is the standard of reasonableness to be entirely objective or is someone intimately involved over a long period with an area of operations of the issuer entitled to rely on her or his experience without showing evidence of "inquiries" or precautions? It would seem practical and reasonable to allow this relaxation of the duty to inquire in some situations.

Other sources of liability

More uncertainty is generated by the existence of sources of potential liability in respect of the content of a prospectus which are external to the prospectus provisions of the Corporations Law.

While ss 999 and 1000 of the Corporations Law (fraudulent, reckless or negligent inducement to deal in securities by dissemination of misleading, false or deceptive information) are unlikely to provide a plaintiff with a cause of action if ss 1018, 996 or 995 do not also do so, there may be other sources of liability which extend to a wider range of fact situations than is usually contemplated in respect of a due diligence process structured around Pt 7.12 of the Corporations Law.

46. Experts: s. 1009(3)(c); advisers: s. 1009(4)(b).
47. Section 1009(4)(c).

For example, does *Trade Practices Act* s. 52 provide for liability in respect of a prospectus not contemplated by s. 995 of the Corporations Law?[48] The tort of deceit insofar as it is relevant to statements in a prospectus seems to be covered by s. 996. Likewise, it is difficult to conceive of a situation where an action in contract for misrepresentation would succeed but an action under the Law fail. Rescission of a sale of shares is available under the Law[49] as well as in an action for misrepresentation. An action in tort for negligent misstatement is probably no more attractive to a plaintiff than an action under the prospectus provisions, either, especially since s. 765 of the Law shifts the burden of proof onto a defendant to prove the reasonableness of the defendant's incorrect forecasts (the Lonergan Report recommended reversal of the onus of proof provided for in s. 765 in the case of forecasts in a prospectus).[50]

The expansive nature of the insider trading provisions of the Corporations Law makes it likely that a technical interpretation of s. 1002G(2) could involve an issuer in a contravention of that section even where the due diligence defence is made out or the prospectus accords with s. 1022. The danger arises because the two sources of liability are based on different tests of the materiality of information: s. 1022 concentrates on the information reasonably required by the market and reasonably obtainable; and Pt 7.11, Div. 2A concentrates on all price-sensitive information in the possession of the corporation and not generally available. The existence of s. 1002E, which deems information in the possession of an officer of a company to be in the possession of the corporation, further extends the potential liability of an issuer which fails to include in a prospectus all price-sensitive information in the possession of its officers. Such a corporation is technically selling or procuring an underwriter to sell securities in contravention of s. 1002G(2), even if that information is not "information which investors would expect to find in a prospectus".[51] Further, the defences provided to a s. 1005 and s. 1006 action for "material omission" from a prospectus will presumably not apply if a "material omission" is defined merely as a failure to include information required under s. 1022, because the omission of inside information may not be a "material omission" in this sense. The corporation and other participants in possession of price-sensitive inside information will therefore be without defences, even where that information is not "information reasonably required by investors", unless the corporation and participants take advantage of the s. 1002T(2) defence by disclosing the relevant information to prospective purchasers. It is to be hoped that the courts would avoid this and other technical flaws in the scheme of the Corporations Law by sensible statutory construction. Nevertheless, these flaws can cause uncertainties in respect of the co-ordination of the due diligence process.

48. Lonergan Report, p. 91.
49. Section 1325(5)(a).
50. Lonergan Report, p. 35.
51. Section 1022.

SENSITIVE, PREJUDICIAL AND CONFIDENTIAL INFORMATION

Decisions to exclude information

Prospectus preparation is a two-stage process: after amassing information retrieved by the due diligence process, the due diligence committee must decide whether any of the information retrieved can be safely excluded from the prospectus.

One of the most interesting grey areas in respect of the prospectus requirements addressed by Nicholson is the question whether directors or other officers in possession of confidential material information may in some circumstances be exempted from the duty to disclose that information in the prospectus. Aspects of this area merit further comment.

Market expectation

The ASC has stated that its exemption powers under s. 1084 of the Corporations Law will not be employed to erode the disclosure requirements of s. 1022.[52] The requirements of s. 1022 for information to be included in a Pt 7.12 prospectus may contain some scope for allowing sensitive information to be withheld because it is only information which "investors and their advisors would *reasonably require and reasonably expect to find in a prospectus*, for assessing the assets and liabilities, financial position, profits and losses, and prospects of the corporation" which must be included in the prospectus.

Arguably, investors would not expect to see confidential or sensitive information in a prospectus. A court might be willing to concede in certain circumstances that an investor would not reasonably expect to see information in a prospectus, the disclosure of which constituted a breach of confidence, whether that duty of confidence arose from a common or nominee director's duty to another company or from a business arrangement. To be distinguished from information subject to a duty of confidence is information which is merely sensitive or potentially prejudicial to the issuing company's interests. "Sensitive information" might relate to either a matter advantageous or a matter disadvantageous to the company's prospects. In the later case it has been the tradition to be more stringent about disclosure, and this might be found by a court to affect the question of what might be reasonably required by investors. But perhaps investors would not expect to see information regarding, say, a new business strategy in a prospectus if they knew that disclosure of that information would damage the issuer's prospects.

What if the "sensitive information" is a forecast? The forecast may not be prejudicial but merely uncertain, yet s. 1022 requires "information

52. ASC Interim Practice Note 9, 27 December 1990.

reasonably required by investors . . . for the purpose of assessing the prospects of the company" if that information is known to company officers and advisers. Not only the level of sensitivity but the level of certainty of information should be relevant to what an investor would reasonably require and expect to see in a prospectus.

Practice and precedent in the takeovers context

Section 750, cl. 17 of the Corporations Law requires that a Pt A Statement set out any "information material to the making of a decision by an offeree whether or not to accept an offer" where the offeror is in possession of such information. Brownie J. in *Austen & Butta Ltd. v. Shell Australia Ltd*[53] raised the alarming possibility that, where an offeror is in possession of information material in this manner but subject also to a duty of confidence, a valid Pt A Statement, and therefore a takeover, may not be possible. Nicholson suggests that the same danger may beset the issuer in possession of confidential information.[54] It is to be hoped, however, that the prospectus content provisions themselves contain some scope for relaxation of strict disclosure in such a case. Section 1022 requires information "reasonably required and reasonably expected to be found in a prospectus". This will be in certain respects a lower level of disclosure than the requirement of "all information material to an investor's decision".

Practice and precedent in the continuous disclosure context

Continuous disclosure by listed entities is currently governed by the Stock Exchange Listing Rules. Listing Rule 3A(1) was recently amended to incorporate a disclosure requirement (para. (c)) in identical terms to s. 1022(1) of the Corporations Law, so it may be inapt to apply principles from stock market disclosure practices to prospectus law rather than doing the reverse. In addition, the Attorney-General has said that the proposed statutory continuous disclosure regime will be less exacting than the prospectus disclosure regime, although it is not clear in exactly what ways the continuous disclosure requirements will be less exacting. The Attorney-General has said that the continuous disclosure rules will allow directors to withhold highly sensitive material, and this may be all that is meant.[55]

But it is worth noting that stock market continuous disclosure requirements phrased in terms similar to Rule 3A(1)(c) have been recognised in some jurisdictions to contain some scope for the withholding of sensitive information.[56]

53. (1992) 10 A.C.L.C. 610.
54. Nicholson, above, p. 344.
55. *Australian Financial Review*, 14 May 1992.
56. E.g. New York Stock Exchange *Listed Company Manual*, Guideline 202.01.

Principles arising in relation to continuous disclosure may not be directly applicable in prospectus law because the level of disclosure and type of information disclosable under the continuous disclosure regime is different from the case of disclosure in a prospectus. But the question arises, "Why the inconsistency?"

This question is of particular importance in the light of the Lonergan Committee's recommendation for a system of "abbreviated rights issue prospectuses" to be introduced with the statutory continuous disclosure regime to offset some of the costs, and silence some of the critics, of the expansion of the prospectus requirements to rights issues.[57]

Insider trading

The uncertainties created by the insider trading provisions of the Corporations Law and noted in this paper[58] are particularly acute in respect of confidential information. There is no scope for reading down the disclosure requirements needed to provide a defence to trading while in possession of price-sensitive information not "generally available" (s. 1002T(2)(b)). Thus, even if the prospectus contents requirements of s. 1022 allows some dispensation for sensitive or uncertain information, the widely-drafted provisions of s. 1002G will have the presumably unintended effect of requiring disclosure of such information. Arguably, this could extend to all forecasts which could be described as likely to materially affect the price of relevant securities, no matter how uncertain or confidential. Yet some forecasts will fail the stringent test of reasonableness provided by s. 765, which deems a forecast "misleading" unless the person making the representation establishes reasonable grounds for the accuracy of the forecast.[59]

Relevant knowledge of participants

Another complication is that participants in prospectus preparation must generally divulge all relevant information in their possession. For example, a lawyer involved in due diligence will only acquire a defence in respect of omissions from the parts of the prospectus for which he or she is responsible if the lawyer, inter alia, believed there were no omissions from the prospectus of material matters. Is the lawyer disqualified from the defence if he or she has knowledge of material information but is bound by a duty of confidence to another client? If *Mallesons Stephen Jaques v. KPMG Peat Marwick*[60] is applicable, as Nicholson suggests it might be,[61] the position of large partnerships overseeing due diligence processes would be untenable. It is to be hoped

57. Lonergan Report, p. 77. See below.
58. See above.
59. See above.
60. (1990) 4 W.A.R. 357.
61. Nicholson, above.

the courts would confine *Mallesons* to cases where the same partnership has acted for both sides in respect of the same discrete matter.[62]

The example Nicholson gives,[63] of a director on an issuer's board who occupies another directorship which gives access to confidential information relevant to the issuer's prospects, raises difficult questions. The best legal option may be to distance such a director from the issue and suspend her or him from office, but the practical effect of this action on the success of the issue might be damaging.

PROBLEMS OF PROOF

A court will experience practical difficulties beyond those already mentioned in trying a case based on omission from, or misstatement in, a prospectus.

One of the most conspicuous examples is the question of causation of loss and assessment of damages. Often a difficult issue, in prospectus proceedings the question of causation will be nearly insoluble. The area is complicated by the fact that *Trade Practices Act* s. 85(1), upon which the key defence provision s. 1011 was modelled, is a provision with operation only as a defence to prosecutions. With a due diligence process structured to attract s. 85(1) protection under the *Trade Practices Act*, no question of causation of a defendant's loss arises.

Under the Corporations Law, however, a court will be asked to assess the losses which flow from a defective prospectus due diligence process and an omission of information causing the prospectus to fall short of the s. 1022 content requirement. *Trade Practices Act* case law will provide no assistance in this task, and the courts will be forced into the most abstract reasoning in order to ascertain damages.

INFORMATION REQUIRED BY INVESTORS

A cursory examination of broker reporting techniques[64] reveals that the information channels which inform the bulk of investment decisions do not depend solely on prospectuses. Although a greenfields venture will be unknown to market analysts and a prospectus will be required to inform the market of the company's prospects, the wisdom of enforcing the prospectus provisions in respect of rights issues by established companies is questionable.

The solution suggested by the Lonergan Committee—the abbreviated rights issue prospectus—is flawed because of the discrepancy between the content requirements of continuous disclosure and those of the

62. In the *Mallesons* case, an injunction was granted against a law firm preventing it from acting for the Crown in a prosecution, confidential information relevant to which the defendants had previously disclosed to the law firm.
63. Nicholson, above, p. 344.
64. Internal briefing materials were kindly provided to us by Potter Warburg Securities Ltd.

prospectus provisions. For example, as mentioned above, there will be provision for sensitive information to be withheld under the statutory continuous disclosure regime proposed by the Attorney-General, but not under the prospectus disclosure regime.[65]

The Lonergan Report was premised on the principle that there is no conceptual difference between disclosure for the purposes of issues and secondary trading and that the market information principle should apply equally to both. How, then, is a differing standard of disclosure for prospectuses and continuous disclosure to be justified? The discrepancy will mean that the abbreviated rights issue prospectus will not be as inexpensive as the Lonergan Committee supposed because all information sources will need to be re-vetted before a rights issue, even if continuous disclosure requirements have been met. Alternatively, the continuous disclosure system operated by the prospective rights issuer will have to be capable of producing prospectus-standard information. The result may well be a prohibitively expensive system of "continuous due diligence".

An indication that the costs of the system are beginning to outweigh the benefits to the market of full disclosure is to be found in the complaints of small investors that companies are raising funds increasingly by excluded issues such as private institutional placements.[66] Another such indication is the growth of the practice of law firms providing due diligence "job quotations". This practice is inimical to the cause of full evaluation of perceived risk areas, because if due diligence is constrained by a predetermined budget, those resources may in fact be inadequate to pursue a thorough investigation of unforeseen risk factors. Of course, there is an unreliable argument that investors would not reasonably expect to see information in a prospectus if the cost of retrieving such information would threaten the viability of the relevant share issue. Another consideration is that the securities industry should be wary about setting a precedent for due diligence on too grand a scale, because in so doing the industry will raise market expectations about prospectus contents, and therefore increase the burden of disclosure provided for in s. 1022.

OUTLOOK

The fact that many small-medium listed resource companies are trading at under asset-backing suggests that there may be rationalisation of the resources industry in the short term. Share-swap takeover schemes are likely to increase in frequency and Pt A statements required to be issued by the offeror in these circumstances will have to conform to the content requirements of s. 1022 as if the Pt A Statement were a prospectus even though Pt 7.12 does not apply to such takeovers.[67]

65. The Lonergan Report did not even mention the question of an exemption for sensitive information.
66. *Business Review Weekly*, 28 February 1992.
67. See Corporations Regulations 6.12.02 and 7.12.02.

When our stock market recovers its confidence in smaller companies (an event which will, one hopes, eventually occur) those smaller companies will want to offer their securities to the market. It will be interesting to see how the current due diligence model, which has been invented and has operated mainly in relation to large issues which can "afford" it, will be adapted to smaller, more speculative issues in a way which will not increase the legal risks of participants materially. A certain amount of indigenous modification of other, foreign, models has already been achieved by the lawyers. Will lawyers be able to create new, but appropriate, adaptations to suit new markets?