COMMENTS

CORPORATE CAPITAL RAISING FROM EMPLOYEES: THE NEED FOR A PROSPECTUS

In a recent article in this review[1] the question was asked whether a corporation, which sought to raise share or loan capital from its employees, would need to do so by means of a prospectus. That question has been partly answered by Needham J. in *New South Wales Corporate Affairs Commission* v. *David Jones*[2]. The decision suggests that corporations may raise loan capital from employees without having to prepare, register and distribute a prospectus, and without having to appoint a trustee for employee-debenture holders. Paradoxically, the decision also carries with it the implication that the raising of share capital from employees may not similarly be free of the prospectus requirements. Above all, the decision highlights the urgent need for a complete reconsideration and restructuring of the prospectus provisions of the Companies Acts.

The defendant company (a subsidiary of David Jones Ltd.) sought to raise funds from employees of the David Jones Group of Companies throughout Australia. In July 1974, and again in September 1974, a document headed "Invitation to the Staff of David Jones Group of Companies" was placed in boxes at the staff entrances to the various stores of the group throughout Australia. There were, at the time, approximately 12,500 employees of the Group. The employees were invited to invest in interest-bearing deposits for periods of up to five years at $12\frac{1}{2}\%$ per annum. The invitation was expressly limited to the staff of the Group. The document stated that applications were to be made on the form on the reverse side of the document. The application forms, together with deposits, were to be lodged at specified offices of the defendant.

As a result of the two invitations, the defendant accepted deposits totalling $348,000 from 237 employees of one of the companies in the Group. The defendant declined to accept deposits from employees of other companies in the Group.

The New South Wales Corporate Affairs Commission sought a declaration that the defendant, by not distributing copies of a registered prospectus with the invitation, had breached s.37 of the N.S.W. Companies Act 1961. It was also alleged that s.38 of the Act had not been complied with. Both of these sections are substantially uniform throughout Australia. S.37 of the Companies Act provides that:

> "(1) A person shall not issue, circulate or distribute any form of application for shares in or debentures of a corporation unless the form is issued, circulated or distributed together with a prospectus a copy of which has been registered by the Commission.
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> Penalty: $2,000
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> (2) Subsection (1) shall not apply if the form of application is issued, circulated or distributed in connection with shares or debentures

1. J. P. Hambrook, "The Provision of Formal Disclosure Documents to Offerees of Corporate Securities", (1975) 5 *Adel. L.R.* 136.
2. [1975] 2 N.S.W.L.R. 710.

which are not offered to the public but otherwise that subsection shall apply to any such form of application whether issued, circulated or distributed on or with reference to the formation of a corporation or subsequently."

The plaintiff argued that the interest-bearing deposits involved the issue of debentures and that the document, distributed to the employees, contained an application form for the debentures. Therefore, s.37(1) was breached unless the debentures were not offered to the public within s.37(2). On this point the plaintiff submitted that an offer to all of the Group's employees was an offer to the public or, at least, an offer to a section of the public. An offer to a section of the public is considered an offer to the public under s.5(6) of the Companies Act.

Did the scheme involve the issue of debentures? "Debenture" is defined by s.5(1) of the Act as including debenture stock, notes and any other securities of a corporation whether constituting a charge on the assets of the corporation or not. This definition was of no real assistance to Needham J. Instead His Honour accepted that a debenture means a document which acknowledges a debt. This is the definition usually adopted by the courts[3]. Indeed, s.5(5) of the Act specifically deems any document to be a debenture that is issued or intended or required to be issued by a corporation acknowledging indebtedness of the corporation in respect of any money that is or may be deposited with the corporation in response to a corporation's invitation to the public to deposit money.

The facts suggested that the defendant may have made two written acknowledgments of deposits. The application forms returned by employees contained a box headed "For Office Use Only". The plaintiff argued that, once these boxes were filled in by the defendant, the forms themselves became debentures. In addition to completing these boxes, the defendant sent letters to depositors acknowledging their deposits. Needham J. agreed that both of these acknowledgments could be considered debentures[4].

Did the documents issued to all of the Group's employees contain forms of application for these debentures? The plaintiff argued that they did, both on general principles and pursuant to s.5(5) of the Act.

The document issued to the employees invited them to make deposits by completing the form on the reverse side of the document and returning it together with the deposits. The plaintiff argued that the employees, by filling out and returning this form, were in fact asking for a written acknowledgment by the defendant of the acceptance of the deposits. The acknowledgments constituted debentures. The plaintiff also argued that the defendant must have intended the forms to be used for that purpose. The defendant, however, submitted that the application made by employees was an application for the acceptance by the defendant of a deposit of moneys rather than an application for a written acknowledgment of such an acceptance.

Needham J. thought that there was no doubt that the defendant intended to issue a written acknowledgment for the deposit of moneys. He also thought

3. See, *e.g., Knightsbridge Estates Trust Ltd.* v. *Byrne* [1940] A.C. 613.
4. With respect, it is difficult to accept that the self-acknowledgment, involved in the defendant making a notation in the "For Office Use Only" boxes, is sufficient for the form to become a debenture. In common parlance an acknowledgment of a debt is made by the debtor acknowledging a debt to someone else.

it unrealistic to suggest the employees did not have an expectation of a similar kind. His Honour then, surprisingly, considered it artificial to describe the application form as an application for a written acknowledgment of a deposit. Rather, he accepted the defendant's characterisation of it as an application, by the proposing depositor, that the defendant accept the deposit on the terms of the offer. With the greatest respect this is surely playing with words. In requesting the defendant to accept their deposits, the depositors were undoubtedly also seeking some written acknowledgment of the acceptance. Needham J. had already thought it "unrealistic" to suggest otherwise. His Honour felt that the plaintiff had to establish that the employees had applied for the precise form of acknowledgment which constituted the debenture. In relation to the acknowledgment in the "For Office Use Only" boxes, Needham J. felt that "to so conclude would be to strain the language of s.37(1); it is a penal provision and must clearly prohibit the conduct complained of."

It is submitted that the precise means by which the defendant corporation acknowledged the deposits should have been unimportant when determining whether s.37(1) applied. What should have been important was that both the defendant and the depositors intended an acknowledgment of deposits to be made and, further, that both parties were aware that the completion and return of the application forms was a condition precedent for the acknowledgment. There was a clear nexus between the completed application form and the acknowledgment of the deposit which constituted the issue of a debenture.

Needham J. felt that his conclusion, that the applications were not applications for debentures, was supported by the wording of s.5(5) of the Act which, he said, implied that in ordinary circumstances an invitation to deposit money with a company does not amount to an invitation to subscribe for or purchase debentures. No reason was advanced as to why s.5(5) has this implication. Presumably his Honour thought that because the subsection "deems" such invitations to be invitations to subscribe for debentures, the invitations would, apart from the subsection, necessarily not be invitations to subscribe for debentures. The view that whenever a statute deems something to be within a definition, the statute is necessarily extending the denotation of the defined term to things it would not in ordinary parlance denote, cannot be accepted. Although this may be the intention of the legislature, it is not necessarily so. The late Mr. Justice Windeyer made this clear in *Hunter Douglas Australia Pty. Ltd.* v. *Perma Blinds:*

> "to deem means simply to judge or reach a conclusion about something, and the words 'deem' and 'deemed' when used in a statute thus simply state the effect and meaning which some matter or thing has—the way in which it is to be adjudged; this need not import artificiality or fiction; it may simply be the statement of an indisputable conclusion"[5].

With respect, there is not necessarily anything artificial or fictitious about an invitation to deposit moneys being regarded as an invitation to subscribe for debentures[6].

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5. (1970) 44 A.L.J.R. 257, 262. See also *St. Aubyn (L.M.)* v. *A. G. (No. 2)* [1952] A.C. 15, 53, *per* Lord Radcliffe.
6. A stronger argument that the legislature intended to distinguish between invitations to subscribe for debentures and invitations to deposit money could be founded on

Having concluded that the application forms were not intended by the parties to be application forms for debentures, Needham J. next considered s.5(5) in detail. This section, as already noted, deems any invitation to the public to deposit money with a corporation to be an invitation to subscribe for debentures. If the defendant's invitation had been made to the public then his Honour would have held that s.37(1) had been breached. However, after reviewing the leading English and Australian authorities on the meaning of "public", Needham J. held that an invitation to all of the Group's 12,500 or so employees was not an invitation to the public. His Honour's view was that an invitation, which is not capable of acceptance by any persons other than a defined section of the community, cannot be a "general" or "public" invitation; the essence of a public invitation is that it is open to anyone who may choose to accept it. His Honour said:

> "No doubt it would be possible to make an invitation to the public, within s.5(5), if it were addressed to a large section of the public, but I cannot see how an invitation which is restricted to a section of the public, in the sense that no one else may apply, can be held to be an invitation 'to the public', within the meaning of that provision."

The plaintiff had attempted to highlight the judgment of Barwick C.J. in *Lee* v. *Evans*[7], the leading Australian authority. The Chief Justice there stated that:

> "the basic concept (of a public invitation) is that the invitation, though maybe not universal, is general; that it is an invitation to all and sundry of some segment of the community at large. This does not mean that it must be an invitation to all the public either everywhere, or in any particular community. How large a section of the public must be addressed in a general invitation for it to be an invitation to the public . . . must depend on the context of each particular enactment and the circumstances of each case. But within that sufficient area of the community the invitation must be general in the sense spoken of by Viscount Sumner in *Nash* v. *Lynde* . . . and by Jordan C.J. in *Ex parte Lovell; Re Buckley*, 'made to the public generally and capable therefore of being acted upon by any member of the public'. That those to whose hands such an invitation is intended to come, also stand in some special relationship to the invitor, will not prevent the invitation being an invitation to the public"[8].

The plaintiff argued that the employees of David Jones could be considered a sufficiently large section of the community to satisfy Barwick C.J.'s concept of "public". Reliance was also placed on the last sentence of the extract quoted above; it was argued that the fact that all of the invitees were employees and thus in "a special relationship" with the defendant did not prevent the offer being a public one. Needham J., wrongly, it is submitted, considered that the last sentence in the extract does not "relate to the ambit of

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s.15 of the Companies Act. S.15(1)(c) requires the memorandum or articles of association of a proprietary company to contain a provision prohibiting any invitation to the public to subscribe for any shares or debentures of the company. S.15(1)(d) requires a similar prohibition on the making of any invitation to the public to deposit money with the company. These sections certainly suggest that depositing money is a very different thing from subscribing for a debenture.

7. (1964) 112 C.L.R. 276.
8. *Id.*, 285-286.

the persons who may accept the invitation, but only to those who, it is intended, shall receive notice of it". In any event, Needham J. felt that the other majority judgments in *Lee* v. *Evans* supported the view that an invitation, which was restricted to a section of the public, in the sense that no one else could apply, could not be an invitation to the public. The other judgments in *Lee* v. *Evans* certainly do support this conclusion.

The plaintiff also contended that, even if the 12,500 employees did not constitute the "public", they did constitute "a section of the public" within the meaning of s.5(6) of the Act. That section provides that "any reference in this Act to offering shares or debentures to the public shall, unless the contrary intention appears, be construed as including a reference to offering them to any section of the public, whether selected as clients of the person issuing the prospectus or in any other manner." The plaintiff argued that, pursuant to s.5(6), the word "public" in s.5(5) had to be read as including "section of the public". Consequently, for the purposes of s.5(5), there had been an invitation to the public to deposit money with the defendant and s.5(5) deemed the invitation to be an invitation to subscribe for debentures. An application form had been issued without a copy of a registered prospectus and, therefore, s.37(1) had been breached.

Needham J. rejected the view that "public" in s.5(5) ought to be construed, in the light of s.5(6), as including "section of the public". His Honour held that s.5(5) was "unrelated" to s.5(6). No reasons were advanced for this conclusion. His Honour explained the position this way:

> "Undoubtedly, the document was an invitation to the recipient to deposit money with or lend money to the defendant, a corporation. If that invitation was an 'invitation to the public', a breach of s.37(1) has been established. An extraordinary confusion now arises. In order to see whether a breach of s.37(1) (as extended by s.5(5)) has been shown, one must determine whether the invitation to deposit moneys was made to 'the public'; there is no provision in the Act which cuts down or defines those words in any way. If the conclusion is reached that the invitation is made to the public, then it is deemed to be an invitation to subscribe for or purchase debentures and, no doubt, s.5(6) would apply to the exemption provisions of s.37(2) so as to limit them, although it would not apply to s.37(1) without the interposition of s.5(5) which is, itself, unrelated to s.5(6). It seems to me that these provisions merit the attention of the legislature."

Presumably, his Honour considered that s.5(5) was unrelated to s.5(6) because the former section relates to "invitations to the public to deposit money" whereas s.5(6) only extends the meaning of "public" where there has been an "offering of shares or debentures to the public". According to Needham J. there had been no offering of debentures by the defendant unless s.5(5) applied to deem the invitation an invitation to subscribe for debentures[9].

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9. There is authority for the view that the word "offer" in the prospectus provisions is not to be interpreted in its strict contractual sense. Referring to s.40(1) of the N.S.W. Companies Act, which attempts to regulate advertisements offering shares in or debentures of a corporation to the public, Sugerman A.C.J. in *A.G. (N.S.W.)* v. *Mutual Home Loans Fund* [1971] 2 N.S.W.L.R. 162, 165, thought it "plain from the context . . . that the 'offering' or 'offer' therein mentioned does not connote an offer in the contractual sense. It refers, rather, in accordance with common usage in these matters, to an invitation to the public to make offers, in the contractual sense, to subscribe for or purchase shares or debentures." Thus the mere fact that s.5(5) refers to "invitations"

S.5(5) only applies to a "public" invitation and, on the facts, there was held to be no such invitation.

Thus the extraordinary result is that s.5(6) can never operate to extend the meaning of "public" in s.5(5). In practical terms, this means that an invitation to deposit money must be made to "the public", in the narrow sense, in order to attract the prospectus provisions. On the other hand, an invitation to apply for shares or debentures need only be made to "a section of the public" before the prospectus provisions are operative. There is no rational point to this distinction. It is the result of the haphazard and clumsy fashion in which the prospectus provisions of the Companies Acts have been built up over the years. This is not the only anomaly in those provisions and, hopefully, Needham J.'s suggestion that "these provisions merit the attention of the legislature" will not be taken lightly[10].

It is noteworthy that this extraordinary, and highly unsatisfactory, result could have been avoided if Needham J. had accepted that, on the facts, the invitations by the defendant corporation to deposit moneys were invitations to apply for debentures. If Needham J. had accepted this view then s.5(5) would have been irrelevant. The defendant would have been guilty of infringing s.37(1) unless the debentures had not been offered to the public. In determining that issue s.5(6) would have applied to extend the meaning of "public" in s.37(2) to "section of the public". Although His Honour made no express finding on the point, there is reason to believe that he would have regarded the 12,500 employees as a section of the public. Referring to the defendant's invitation, he remarked that he could not see how "an invitation which is restricted to a *section of the public*, in the sense that no one else may apply . . ." could be an invitation to the public.

Mr. Justice Needham's opinion that s.5(6) could not add to the meaning of "public" in s.5(5) also meant that there had been no breach of s.38. S.38(1) makes it an offence to issue an invitation to the public to deposit money with or lend money to a corporation unless a prospectus in relation to the invitation has been registered. S.5(6) could not operate to extend the meaning of "public" in s.38(1) to cover "section of the public" without s.5(5) first operating to deem the invitation an invitation to subscribe for debentures. S.5(5), of course, would not have this effect unless there had been a "public invitation" in the ordinary sense of that term. On the facts there was held to be no invitation to the public.

The result in *C.A.C.* v. *David Jones* is indeed alarming. It means that any corporation, no matter what its size or number of employees, may raise loan funds from employees without the employees being entitled to any disclosure document. All that a corporation has to do is to avoid using the word "debenture" when making its offer or invitation. If, as in the David Jones case, the corporation merely invites employees to deposit money with it the

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whereas s.5(6) and s.37(2) refer to "offers" would not, in itself, mean that the sections are unrelated. Needham J.'s statement that s.37 would have been breached had there been an invitation to the public under s.5(5) suggests that his Honour was not prepared to distinguish between "invitations" and "offers".

10. It is noteworthy that cl.10 of the lapsed Australian Labor Government's Corporations and Securities Industry Bill, 1975, would have remedied this anomaly in the Companies Acts. Under that clause, the invitation to deposit money with the defendant company would clearly have been deemed to be an invitation to subscribe for debentures. Clause 161, read together with cl.12, would have then operated to require the invitation to have been made by means of a prospectus if the invitation was directed at the public or a section of the public.

corporation will not be considered to have offered debentures to the employees. Not only will no prospectus be required, but there will be no need to appoint a trustee for the debenture-holding employees[11], or to include, in any relevant debenture trust deed, the covenants required when debentures have been offered to the public for subscription[12]. Legislative protection for employee debenture-holders will, in short, be minimal. It is submitted that the need for amending legislation is urgent.

Mr. Justice Needham at no stage of his judgment discussed the purpose of the prospectus provisions. The plaintiff had argued that the provisions ought to be interpreted in the light of their aim, which was to protect members of the public, including company employees, from making unwise investments. In ignoring the plaintiff's submission his Honour acted in a manner consistent with earlier authorities. As this writer has indicated elsewhere[13], the attitude of English and Australian courts to the prospectus provisions, and the "offer to the public" concept in particular, is significantly different from that of the United States courts. The 1933 U.S. Securities Act states that no prospectus or registration statement is required for a private or non-public offering of securities. In *S.E.C.* v. *Ralston Purina*[14], a case concerning an offer of securities to a corporation's employees, the United States Supreme Court held that the meaning of "private" had to be ascertained in the light of the statute's aim of protecting investors by promoting full disclosure of information thought necessary to informed investment decisions. The Court stated that "an offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering'." In relation to offers of securities to employees the Supreme Court said:

> "The (private offering) exemption, as we construe it, does not deprive corporate employees, as a class, of the safeguards of the Act. We agree that some employee offerings may come within (the exemption); e.g. one made to executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement. Absent such a showing of special circumstances, employees are just as much members of the investing 'public' as any of their neighbours in the community"[15].

There are undoubtedly sound business and social reasons for a corporation seeking to raise its capital, particularly share capital, from its employees. The current widespread interest in employee share ownership plans has focussed attention on the advantages of directly involving employees in the capital structure of firms. The existing Companies Acts in several senses recognise and encourage the practice. Sub-ss.67(2)(b) and (c), for example, permit a corporation to finance acquisitions of its shares by employees or trustees for employees. This is one of the few exceptions to the rule prohibiting a corporation from assisting persons to purchase its own shares.

Ironically, even though *C.A.C.* v. *David Jones* may encourage corporations to raise loan capital from employees, the decision may discourage the raising

11. Needham J. held that debentures were in fact issued to the successful employee applicants. S.74 of the Companies Act requires every corporation which offers debentures to the public for subscription to provide for the appointment of a trustee for the debentureholders. In the David Jones situation s.74 would not apply because debentures had not been offered to the public.
12. S.74b of the Companies Act only stipulates covenants for trust deeds if a corporation offers debentures to the public.
13. Hambrook, *loc. cit.*, 137-143.
14. 346 U.S. 119 (1952).
15. *Id.*, 125-126.

of share capital. In so far as Needham J's. judgment suggests that the David Jones employees were "a section of the public" it means that a prospectus would have been required had shares, rather than debentures, been issued to employees. Any offer or invitation relating to shares for subscription would clearly bring s.5(6) of the Act into play with the result that an invitation to the employees, as a section of the public, would probably require a prospectus. Assuming that Needham J. would consider an offer to all 12,500 David Jones employees an offer to a section of the public, would an offer by any company to its employees as a group be similarly regarded? Does anything turn on how many employees are involved or on the nature of the company making the offer? If the number of employee-offerees is relevant then how many employees constitute a "section of the public"? Neither Needham J's. decision nor the provisions of the Companies Act materially assist in answering these important questions. Nor is it clear whether a proprietary company, which seeks to make all of its employees security-holders, runs the risk of infringing s.15(1)(c) and (d) of the Act. These sections effectively prohibit such companies from inviting the public to subscribe for shares or debentures or to deposit money with the company. It is also unclear whether a company which offers securities to something less than 100% of its employees will be subject to the prospectus provisions. Given the interpretation of "public offer", as one which is capable of acceptance by anyone who chooses to come in and accept it, it is possible that an "offer to a section of the public", such as a company's employees, means that it must be capable of acceptance by all members of the "section of the public". If this is correct then a corporation could easily avoid the prospectus provisions by arbitrarily excluding one or more of its employees from the offer. There is clearly an urgent need for legislative guidance in this area.

It is submitted that, *prima facie*, all employees who are offered their employer's securities are deserving of whatever protection is afforded by the information required to be included in a company prospectus. No intelligent distinction can be drawn between share and loan capital raising. Nor should it matter whether securities are offered directly to employees or to a trustee for employees. Employees are deserving of protection in both cases, although in the latter, if no consideration moves, or is to move, from the employee beneficiaries, it may be enough for the trustee to be provided with the necessary information. The important point to be stressed is that employee involvement in a corporation's capital structure ought not to be obtained at the expense of employees. The legislature has a duty to see that employees are not coerced or misled by their capital-raising employers. In requiring corporations to satisfy appropriate disclosure requirements the legislature will be going part of the way toward providing the necessary protection. As the United States Supreme Court said in *Ralston Purina:*

> "once it is seen that the (private offering) exemption turns on the knowledge of the offerees, the issuer's motives, laudable though they may be, fade into irrelevance. The focus of inquiry should be on the need of the offerees for the protection afforded by registration. The employees here were not shown to have access to the kind of information which registration would disclose. The obvious opportunities for pressure and imposition make it advisable that they be entitled to compliance with [the prospectus provisions]"[16].

*J. P. Hambrook**

16. *Id.*, 126-127.

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