GOOD FAITH AND DEALING WITH DISSENT IN PROSPECTUSES

John H Farrar*

In corporate law a prospectus provides the basis upon which an investor invests in a company.[1] It is often referred to as a contract but this is oversimple An important question of principle is whether a prospectus gives rise to an obligation of or approximating to good faith and, if so, what that entails in this context A further question is whether the use of such concepts in relation to prospectuses serves a useful social purpose In order to examine these issues, this article will first consider the nature of a prospectus and the duty of disclosure in respect of a prospectus at common law, in equity and pursuant to statute. Then follows a discussion of the *Fraser v NRMA Holdings Ltd* decisions,[2] and the extent (if any) to which a disclosure of dissent by members of the board of directors is required as a matter of good faith. The conclusion canvasses the Corporate Law Economic Reform Program, and its prospective effect upon the duty of disclosure in prospectuses.

INTRODUCTION

Gummow J said in *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd*: 'The concept of 'good faith' appears in various areas of the law, in each case with a distinct body of authority as to its meaning and application.'[3]

As such it is a concept of both common law and equity, as well as statute law, but its meaning tends to be elusive and ultimately, relative English and Australian civil and commercial law[4] lacks a unifying

---

* Professor of Law at Bond University and Professorial Associate at the University of Melbourne

1 See: J H Farrar et al *Company Law* (1st ed, 1985) 481

2 *Fraser v NRMA Holdings Ltd* (1994) 12 ACLC 855 (Federal Court of Australia, Gummow J) Affd *Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452 (Full Court of the Federal Court of Australia) ('the *NRMA* case.)

3 (1993) 45 FCR 84, 91

4 See generally: J F O Connor, *Good Faith in English Law* (1990); J Beatson and D

doctrine of good faith such as exists for example under the German Civil Code[5] or the Uniform Commercial Code (UCC) of the USA.[6] Nevertheless a strong view was expressed by Priestley JA in *Renard Constructions (ME) Pty Ltd v Minister for Public Works*[7] that people have grown used to the courts applying standards of fairness to contract which are wholly consistent with a duty of good faith and fair dealing in its performance and this is now the expected standard

However that may be, good faith is an important foundation of a director's fiduciary relationship to his or her company This may have influenced early views of the company's obligations to potential investors before the modern doctrine of separate legal personality was firmly established, as well as influenced the Full Court of the Federal Court in *Fraser v NRMA Holdings Ltd*[8] in its application of s 52 of the *Trade Practices Act 1974* which deals with misleading and deceptive conduct

Some of the early English cases after the modern *Companies Acts* indicated that a prospectus was a contract of the utmost good faith while others disagreed, and the matter appeared to have been finally resolved in the negative by the House of Lords in *Aaron's Reefs Ltd v Twiss*[9] in 1896 Nevertheless some of the older cases are still cited and we now have the Australian decision in *Fraser v NRMA Holdings Ltd* which has reopened the whole question in the complex context of the Australian legislation

Another interesting question of principle which shall be considered later in this paper is whether the duty of disclosure generated by the general duty of good faith or its Australian equivalent entails detailed disclosure of dissent on the board of directors.

Friedmann (eds), *Good Faith and Fault in Contract Law* (1995) chh 6, 7; M Clarke *The Common Law of Contract in 1993 Will There Be a Doctrine of Good Faith?* (1993); Raphael Powell, Good Faith in Contracts (1956) 9 *Current Legal Problems* 16; R Brownsword Good Faith in Contracts Revisited (1996) 49 *Current Legal Problems* 111; M G Bridge Does Anglo Canadian Contract Law Need a Doctrine of Good Faith? (1984) 98 *Canadian Business Law Journal* 385; H Lucke, Good Faith and Contractual Performance in P Finn (ed), *Essays on Contract* (1987) ch 5; Mr Justice Steyn, The Role of Good Faith and Fair Dealing in Contract Law: A Hair Shirt Philosophy? [1991] *Denning Law Journal* 131; R Goode The Concept of Good Faith in English Law , Centro di Studi e Ricerche di Diritto Comparito e Straniero Rome 1992.

5 For the German Civil Code see BGB art 242 and Staudinger, *Kommentar zum BGB*.

6 For the US UCC see article 1-203; R Summers Good Faith in General Contract Law and the Sales Provision of the Uniform Commercial Code (1968) 54 *Virginia Law Review* 195;Allan E Farnsworth, Good Faith in Contract Performance in J Beatson and D Friedmann (eds) *Good Faith and Fault in Contract Law* (1995) ch 6

7 (1992) 26 NSWLR 234 268.

8 (1994) 12 ACLC 855 Affd *Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452; 13 ACLC 132

9 [1896] AC 273

THE NATURE OF A PROSPECTUS

The functions of a prospectus are threefold. It states a proposal which the company wishes to place before the public; it discloses to the public the information relevant to the proposal; and it provides the basis for the necessary contracts to implement the proposal

A prospectus does not usually constitute an offer in the strict sense of the law of contract. In most cases, it states the terms — both fact and opinion — which constitute the proposal being put to the public To this extent, it is an invitation to treat but it also usually sets out a description of the 'contractual matrix'[10] which will ensue The sequence will then be as follows:

⇒ *Invitation* by the company contained in the prospectus,

⇒ *Offer* by the investor to the company,

⇒ *Acceptance* by the company,

⇒ *Performance* by the allotment of securities.

In the case of a rights issue, however, the prospectus constitutes an offer. The allotment of the securities then gives rise to a further set of legal relationships constituted by the articles or trust deed.

THE DUTY OF DISCLOSURE AT COMMON LAW AND IN EQUITY

In the period 1861 to 1896 the duty of disclosure was often expressed strictly The earliest modern case is *The New Brunswick and Canada Railway Co Ltd v Muggeridge*[11] where Kindersley VC said:

> those who issue a prospectus holding out to the public the great advantage which will accrue to those who will take shares in a proposed concern and inviting persons to take shares on the faith of the representations therein contained, are bound to state everything with strict and scrupulous accuracy and not only to abstain from stating as fact that which is not so, but also to omit no fact within their knowledge, the existence of which might, in any degree, affect the nature or extent or quality of the privileges and advantages which the prospectus holds out as inducements to take shares

In *Ross v Estates Investment Co*[12] Page Wood VC said that it was essential that there should be 'uberrima fides — a most complete disclosure of the facts.' An earlier explanation by Turner LJ in *Kisch v Central Railway of Venezuela*[13] that all that was required were 'fair,

10 See: New Zealand Securities Commission, *Proposed Recommendations for Securities Regulations* 20 March 1980

11 (1861) 30 LJ Ch 242, 249-50

12 (1867) 3 Eq 122, 136

13 (1865) 3 De GJ & S 122; 46 ER 584 589

honest and bona fide statements' was explained The latter case, however, was upheld in the House of Lords in *Central Railway of Venezuela v Kisch*[14] where Lord Chelmsford LC expressed the matter thus:

> The alleged representations are contained in a prospectus, the object of which was to invite the public generally to join the proposed undertaking In an advertisement of this description some allowance must always be made for the sanguine expectations of the promoters of the adventure and no prudent man will accept the prospects which are always held out by the originators of every new scheme, without considerable abatement
>
> But although, in its introduction to the public some high colouring, and even exaggeration, in the description of the advantages which are likely to be enjoyed by the subscribers to an undertaking, may be expected yet no misstatement or concealment of any material facts or circumstances ought to be permitted In my opinion the public, who are invited by a prospectus to join in any new adventure ought to have the same opportunity of judging of everything which has a material bearing on its true character, as the promoters themselves possess It cannot be too frequently or too strongly impressed upon those who, having projected any undertaking, are desirous of obtaining the cooperation of persons who have no other information on the subject than that which they choose to convey, that the utmost candour and honesty ought to characterise their published statements

He then cited Kindersley VC in *The New Brunswick & Canada Railway Co v Muggeridge*[15] In the House of Lords case of *Aaron's Reefs Ltd v Twiss*[16] Lord Watson stated clearly that the duty of disclosure is not the same -

> as in the case of a proposal for marine insurance In an honest prospectus many facts and circumstances may be lawfully omitted, although some subscribers might be of opinion that these would have been of materiality as influencing their judgment But the statement of a portion of the truth accompanied by suggestions and inferences which would be possible and credible if it contained the whole truth, but become neither possible nor credible whenever the whole truth is divulged is to my mind neither more or less than a false statement

From then on the matter has tended to be the subject of detailed regulation by statute and listing requirements although in *Flavel v Giorgio*[17] there was still said to be a duty of 'utmost candour and honesty,' echoing the 1867 dictum of Lord Chelmsford LC

The Statutory Duty of Disclosure in Australia

Australian securities regulation in the last two decades has been weighted towards investor welfarism[18] as an analogue of consumer

14 (1867) LR 2 HL 99, 113
15 (1861) 30 LJ Ch 242
16 [1896] AC 283, 287
17 (1990) 2 ACSR 568
18 Cf J Adam and R Brownsword *Understanding Contract Law* (1987) 162-4

protection. The provisions, influenced also by local constitutional questions, have resulted in dense and complex law in the Corporations Law which often defies common sense.

Section 1021 of the Corporations Law lists specific information to be included in a prospectus in Australia. This is supplemented in general terms by s 1022 which basically adopts the test of all such information as investors and their professional advisers would reasonably require and reasonably expect to find in a prospectus to make an informed assessment of corporate assets etc and the rights attaching to the securities.

There are provisions prohibiting misleading and deceptive statements in s 995 and false or misleading statements and omissions in s 996. These involve some overlap. Section 996 is a criminal offence. There are civil remedies under s 1005 in respect of both sections. Section 995 is based on s 52 of the *Trade Practices Act 1974* which also applies. Section 52 is aimed at misleading and deceptive conduct and was used in the *NRMA* case. It creates a statutory tort of uncertain scope and appears to be based on a 1938 amendment to s 5 of the US *Federal Trade Commission Act 1914*. Originally the latter was confined to 'unfair methods of competition in commerce' but in 1938 was amended to strike at 'unfair or deceptive acts or practices in commerce'.

In 1978 in *Hornsby Building Information Centre Ltd v Sydney Building Information Centre Ltd*,[19] Stephen J said:[20]

> The United States section, when first enacted in 1914 was exclusively concerned with 'unfair methods of competition in commerce' and only in 1938, when amended so as to strike at 'unfair or deceptive acts or practices in commerce' did it for the first time also embrace within its scope the subject of consumer protection (55 Am Jur 2d par 736). Section 52 of our Act ... on the contrary ... says nothing about unfair acts or practices but devotes itself to the prohibition of conduct which misleads or deceives.

Thus Donald and Heydon in their work *Trade Practices Law*[21] state: 'In short, s 52 may catch unfair conduct between traders, but only to the extent that it is misleading or deceptive.' Constitutional concerns about giving the judiciary a non judicial power, as well as scepticism about the vagueness of fairness as a standard, led to the present Australian wording.

Under s 82 of the *Trade Practices Act*, a person who suffers loss or damage by reason of a contravention of s 52 may recover the amount of the loss or damage from the corporation or any other person involved in

---

19 (1978) 140 CLR 216

20 Ibid 227

21 Bruce G Donald and J D Heydon, *Trade Practices Law Restrictive Trade Practices, Deceptive Conduct and Consumer Protection* (1978) vol 2 [11.1.3]

the contravention. There are no defences The due diligence type of defences in ss 1008A, 1009 and 1011 of the Corporations Law do not apply to a breach of s 52 of the *Trade Practices Act*.

A question relevant to this paper is whether one can rationalise the voluminous and diverse caselaw under s 52 on the basis of a principle of good faith Although Carter and Furmston in 'Good Faith and Fairness in the Negotiation of Contracts Part II'[22] consider that this would be an error, they concede that the result of a breach may be tantamount to a breach of a duty of good faith

In *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd*[23] Gummow J sitting in the Federal Court rejected the implication of a term requiring the respondent to act in good faith and made some useful remarks about the concept in Australian and US laws With regard to s 52 his Honour said that it is directed not to classes of case but to the circumstances of a particular case, something not adequately or readily accommodated in the implication of a term by law [24]

Thus Australia arguably has too much law on prospectuses and remedies for any misstatements in them and lacks some unifying conceptual scheme. This no doubt explains the dissonance between the substantive obligations, due diligence regimes and due diligence defences in the Corporations Law, and s 52, all of which were exposed in the *NRMA* case

THE *NRMA* CASE

NRMA Limited ('the Association') is a company limited by guarantee formed to incorporate an association to provide services to motorists. NRMA Insurance Limited ('Insurance') is also a company limited by guarantee to carry on business as an insurer The articles of Insurance gave the Council of the Association power to appoint the board of directors of Insurance.

A scheme for 'demutualization' of the Association and Insurance was developed by a majority of the directors of the Association. This involved the formation of a public company limited by shares, NRMA Holdings Limited ('Holdings') which was to acquire ownership and control of the Association and Insurance from the members Holdings issued a prospectus offering the members 'Free Shares' in Holdings or cash in lieu for giving up their rights of membership of the Association and Insurance Also sent out were notices of general meetings of the two

22 (1995) 8 *Journal of Contract Law* 93, 99
23 (1993) 45 FCR 84
24 Ibid 92

companies. Two dissentient directors of the Association applied for an injunction on the ground that the prospectus was misleading and deceptive under s 52 of the *Trade Practices Act 1974*

Gummow J at first instance[25] granted the injunction inter alia on the ground that the term 'Free Shares' was misleading and deceptive and that more candour was necessary over the statements that there would be no change in the nature of the services after the demutualization. He said by way of obiter that, although the law does not require a board to circulate the views of dissentient directors, nevertheless in a given case a practical and effective means of equipping members of a widely held corporation with enough information to make a properly informed judgment might be the distribution of written reasons advanced by minority directors for their views.[26]

The Full Court of the Federal Court dismissed an appeal. The court held that:[27]

1 The directors had a fiduciary duty to disclose relevant information in relation to proposals to be considered in general meeting. The duty was to provide such material information as would fully and fairly inform members of what was to be considered at the meeting. The information should enable members to judge for themselves whether to attend the meeting and vote

2 Section 52 does not by its terms impose an independent duty of disclosure which would require a corporation or its directors to give particular information to members. Nevertheless where information is promulgated the combination of what is said and what is left unsaid may, depending on the full circumstances, be likely to mislead or deceive the membership unless the information given constitutes a full and fair disclosure of all the facts which are material to enable members to make an informed decision

3. The need to make full and fair disclosure had to be tempered by the need to present a document which was intelligible to reasonable members of the class to whom it was directed, and which was likely

---

25 (1994) 12 ACLC 855

26 Ibid 869.

27 (1995) 55 FCR 452; 13 ACLC 132. See the note by W J Koeck [1995] *Butterworths Company Law Bulletin* 55; R Langton. Material and Immaterial Omissions from a Prospectus: Reflections of a Puzzled Observer on the Decision(s) in *Fraser v NRMA Holdings Ltd* (1996) 6 *Australian Journal of Corporate Law* 410; M Legg, Misleading and Deceptive Conduct in Prospectuses (1996) 14 *Company and Securities Law Journal* 47; M Gillooly, Misleading and Deceptive Conduct under s 995 of the Corporations Law in C Lockhart (ed), *Misleading or Deceptive Conduct — Issues and Trends* (1996) ch 4

to assist rather than to confuse.[28] In this case, the membership of the Association comprised a wide cross-section of the community, many of whom would have had no experience in dealing with shares. In cases such as the present, it might be necessary to be selective in the information provided, confining it to that which was realistically useful. In the circumstances, the Court would not be quick to conclude that a contravention of s 52 had occurred because other information could have been provided that was not.

The Full Court said little about dealing with dissent except to indicate that this may have been a way of dealing adequately with disadvantages of the proposals. This seems to echo the general jurisprudence on disclosure, some of which is predicated on a duty of good faith. Is it possible to equate the two? Is the duty under the Corporations Law a duty of good faith, and does this amount to the same thing as a duty not to mislead and deceive?

The answers seem to be as follows:

(1) The better view in the past has been that the corporate law duty falls short of a duty of the utmost good faith.

(2) Apart from the statutory duties and listing requirements of disclosure, there is no positive duty to disclose.

(3) Where disclosure is made, the principle of *suppressio veri suggestio falsi* applies, both under corporate law and s 52.

(4) The duty not to mislead or deceive is part, but not the whole, of a duty of good faith.

(5) The duty of good faith involves a JL Austin "trouser word" situation[29] in that it is difficult to define except by considering its converse. Thus the negative or, in this case, bad faith "wears the trousers" in the relationship. Gummow J, in an interesting judgment in *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd*,[30] considered that good faith was an example of a category of indeterminate reference.[31]

(6) Nevertheless it is arguable that s 52 and its corporate counterpart in s 995 provide some basis for arguing that in Australia there is now a general duty of good faith.[32]

---

28 *Devereaux Holdings Pty Ltd v Pelsart Resources NL* (1986) 4 ACLC 12; *In re Dorman Long & Company Ltd* [1934] 1 Ch 635.

29 *Sense and Sensibilia* referred to by R Summers, Good Faith in General Contract Law and the Sales Provision of the UCC (1968) 54 *Virginia Law Review* 195.

30 (1993) 45 FCR 84, 91.

31 See: J Stone *Legal System and Lawyers Reasonings* (1968) 263.

32 See: CJF Boge, 'Does the Trade Practices Act Impose a Duty to Negotiate in Good Faith?' (1998) 6 *Trade Practices Law Journal* 4 and 68.

Dealing with Dissent in Prospectuses

The next question is whether the traditional duty, the modern statutory duty or the emerging duty under s 52 entail any specific way of dealing with dissent in the prospectus. It has hitherto been regarded as axiomatic that, absent any contrary provision in the articles, the board acts as a collegiate body and by majority rule.[33] It has also been accepted that the board can advocate its own views and use the proxy machinery of the company to support them, subject to compliance with listing requirements.

The Privy Council decision in *Campbell v The Australian Mutual Provident Society*[34] is authority for the proposition that the board can put forward its views and there is no obligation on a board of directors to circulate contrary arguments on behalf of dissentient directors. It is for the dissentients to circulate their views at their own cost if they wish.

In Australia there is a specific statutory requirement under s 750 of the Corporations Law to include the dissentients' case in a Takeover Part B statement and a requirement under the Corporations Regulations Schedule 8 Part 3 Para 1 (a) (iii) to do likewise in the case of a Scheme of Arrangement with members. There has not hitherto been such a requirement in the case of a prospectus because non-consenting directors are not parties to it and indeed must themselves give reasonable public notice of this fact under s 1008(3) of the Corporations Law. This different way of dealing with prospectuses has been in force for some time in Australia and the United Kingdom

In *Fraser v NRMA Holdings Ltd*[35] at first instance Gummow J said by way of obiter:[36]

> However, even if the law does not in terms require it, in a given case a practical and effective means of equipping members of a widely held corporation to make a properly informed judgment and of avoiding their being misled or deceived by inadequate disclosure, may be the distribution of written reasons advanced by minority directors for their dissentient views upon a particular proposal which is to be put before a general meeting of members

The Full Court seemed to agree without further comment.[37]

---

33 See: *D'Arcy v Tamor Kit Hill and Callington Railway Co* (1867) LR 2 Ex 158, 161; *Re Haycroft Gold Reduction & Mining Co* [1900] 2 Ch 230, 235

34 (1908) 24 TLR 623

35 (1994) 12 ACLC 855

36 Ibid 869

37 (1995) 55 FCR 452; 13 ACLC 132

Thus misleading and deceptive conduct under s 52 of the *Trade Practices Act* and s 995 of the Corporations Law, operating like a good faith requirement, now arguably require disclosure of dissent, at least as a matter of caution.

Conclusion

Early English cases supported by limited Australian authority conceived a prospectus to be a contract of the utmost good faith That view was later superseded although echoes of the earlier authority still resound in modern textbooks.[38]

Australia has a complex statutory scheme for prospectus disclosure and remedies for misstatement and has too many overlapping provisions [39]

The application of s 52 of the *Trade Practices Act 1974* has made the complexity even more difficult to cope with. The result is draconian law and a dissonance between the Corporations Law, s 52 and due diligence procedures, resulting in massive litigation for professional negligence against some of Australia's leading corporate lawyers.

In its own muddled way Australia seems to be stumbling towards a position put forward in 1867 that prospectuses are a contract of the utmost good faith, a view which, as referred to above, was later discarded. As a problematic corollary, there are now strong dicta that suggest that the disclosure obligation necessitates a report of the dissenting directors' views to avoid the risk of being misleading and deceptive This goes further than company law in any jurisdiction has gone to date and is contrary to well established rules of corporate governance based on the principle of majority rule [40]

One can question the social utility of the use of categories of indeterminate reference such as good faith and even misleading and deceptive conduct Good faith represents a problematic concept in ethics and existentialist philosophy. The law's use of such categories creates uncertainties and has increased the transaction costs of business The application of either or both categories in the case of prospectuses, with the current lack of corresponding due diligence defences, has led to calls for reform by the legal profession and business groups.

---

38 See, eg: P Davies *Gower's Principles of Modern Company Law* (6th ed 1997) 407 Compare HAJ Ford, R Austin and I Ramsay, *Ford's Principles of Corporations Law* (9th ed, 1999) [22 280]

39 See: HAJ Ford, R Austin and I Ramsay *Ford's Principles of Corporations Law* (9th ed 1999) [22 280] and [22.410] ff

40 *D'Arcy v Tamar Kit Hill and Callington Railway Co* (1867) LR 2 Ex 158, 161; *Re Haycroft Gold Reduction & Mining Co* [1900] 2 Ch 230, 235

The Law's intervention in prospectuses can be justified in terms of informationally impaired markets as well as investor welfarism, a factor which weighed heavily with the Federal Court at first instance and on appeal. However it is important that this should be seen, as Michael Trebilcock has said of unconscionability, as a 'constrained tool of intervention and not as the basis for unfettered judicial second guessing of market participants.'[41] It is arguable that the current law leads to the latter.

The latest proposals of the Corporate Law Economic Reform Program of Treasury[42] are to remove the overlap between ss 995 and 996 and to provide that s 52 of the *Trade Practices Act 1974* shall no longer apply to securities dealings. Instead it is proposed to provide a self-contained liability regime for them. Under what are now cll 728-30 of the Corporate Law Economic Reform Program Bill 1998, recovery of damages will depend upon:

(1) a misleading or deceptive statement, or

(2) an omission of material required by other sections, or

(3) a new circumstance which would have been required if it had arisen before the disclosure document was lodged.

Loss or damage must be proved. The criminal offence for omissions will be based upon it being materially adverse from an investor's point of view (cl 728(3)). There are defences under cll 731-33. Clause 731 is a due diligence defence.

It is too early to say when these provisions will be enacted and precisely what their effect will be. It seems likely, therefore, that despite possible improvement in the intelligibility of the Australian statute law we will still be left with no definitive answers to the questions whether the duty of the company to investors amounts to a duty of good faith and whether this entails disclosure of the views of dissentient directors. We will also be left with a system which is still a basis for relatively unstructured judicial second guessing of market participants.

One is reminded of the remark of my distinguished mentor, Raphael Powell, in his inaugural lecture as Professor of Roman Law at

41 See: M Trebilcock 'An Economic Approach to the Doctrine of Unconscionability' in B J Reiter and J Swan (eds) *Studies in Contract Law* (1980) ch 11.

42 Department of the Treasury, *Corporate Law Economic Reform Program. Commentary on Draft Provisions* (1998) 12-13. See also Report of the Simplification Task Force, Section 52 Trade Practices Act and Dealings in Securities (1996) and the Final Report of the Financial System Inquiry (1997). For interesting recent criticisms of the CLERP proposals, see *The Australian* 9 June 1998 26.

University College London in 1956 when he said 'When I read of a lawyer trying to tread daintily in the china-shops of ethics, I wish that someone would lead him back into the streets where walk all manner of men'[43]

---

43 R Powell, Good Faith in Contracts' (1956) 9 *Current Legal Problems* 16, 38 Powell favoured a good faith regime but eschewed an abstract philosophical approach However, compare the view of R Brownsword, 'Good Faith in Contracts Revisited' (1996) 49 *Current Legal Problems* 111 157