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DISCLOSURE OF RISKS IN A PDS

Woodcroft-Brown v Timbercorp Securities Limited (in Liq) & Ors [2011] VSC

The Victorian Supreme Court has clarified the disclosure obligations of responsible entities when issuing product disclosure statements for managed investment schemes. In *Woodcroft-Brown v Timbercorp Securities Limited (in Liq) & Ors* [2011] VSC Judd J dismissed a class action brought by investors in Timbercorp's agribusiness schemes who were seeking to avoid liability for loans entered into with Timbercorp to finance their investment in the relevant schemes.

Background

Timbercorp Securities Limited ran a number of registered managed investment schemes relating to horticultural and forestry projects. There were a number of different product disclosure statements issued in relation to the projects. The fifth defendant, Timbercorp Finance Pty Ltd, provided finance to investors in the schemes. Despite presenting an apparently healthy financial position in its 2008 Annual Report (published at the end of December 2008), the Timbercorp group collapsed in June 2009. The plaintiff, Mr Woodcroft-Brown, had invested in various Timbercorp projects. He commenced class action proceedings on behalf of himself and others who had invested in Timbercorp projects in the period between 6 February 2007 and April 2009 alleging:

- that the product disclosure statements that were prepared by Timbercorp Securities were defective because they did not disclose information about certain risks as required by the *Corporations Act*; and
- misleading and deceptive conduct.

The plaintiff argued that had the relevant risks been disclosed and had the misleading and deceptive conduct not occurred, he would not have invested in the scheme and would not have borrowed money to do so. The relief claimed included an order that he and other members of the class action group were not liable to repay their loans from Timbercorp Finance.

The judge was critical of the complexity of the plaintiff's case as pleaded, and also critical of the fact that the case advanced by the plaintiff at trial differed from that pleaded. (The change to the case did not result in an application to amend the statement of claim and the plaintiff maintained that his case at trial fell within his existing pleading. His Honour commented that he would have been likely to refuse any application for leave to amend and held that the plaintiff should be confined to the case as pleaded.) His Honour noted that the plaintiff's case had the potential to be made relatively straight forward, but that any potential for simplification was not realised, because the plaintiff expressly refused to abandon any element of his case – 'In his attempt to cover every possible combination or permutation of fact and law … the plaintiff constructed an elaborate and sometimes illusive web of allegations'.

The plaintiff failed. The judge found that the product disclosure statements did contain the disclosure about significant risks required under the *Corporations Act*, that there was no misleading and deceptive conduct and that in any event the plaintiff had failed to establish the necessary reliance and causation. In a lengthy judgment (lengthy no doubt as a consequence of the complexities in the way that the case was run referred to above) His Honour gave some useful guidance on what needs to be disclosed in product disclosure statements for managed investment schemes.

Alleged breaches of Corporations Act requirements and misleading and deceptive conduct

Section 1013C of the *Corporations Act* prescribes certain information and statements that must be included in a compliant product disclosure statement. If the information is not included, the product disclosure statement is defective and a person who suffers loss or damage as a result is entitled to recover the amount of the loss or damage from the person who prepared the product disclosure statement (section 1022B).

In particular, a product disclosure statement must disclose information about any significant risks associated with holding the financial product (Section 1013D(1)(c)). The amount of information required is that which a person would reasonably require for the purpose of making a decision, as a retail client, whether to acquire the financial product.

The plaintiff argued that the following were significant risks that should have been disclosed in the product disclosure statements relating to the Timbercorp projects, but were not:

- a structural risk relating to the financial structure of the Group business, being a risk that the Group might fail to discharge its contractual obligations (which the judge characterised as the performance risk) due to financial incapacity because of insufficient cash flow should members of other schemes fail to make contributions or because the group might not be able to obtain or service external debt or because it could not access funds by securitising investor loans;
- the risks relating to certain adverse matters, the three most important of which were an announcement in February 2007 of a proposal by the ATO to change its position on the deductibility of upfront fees paid by investors, the global financial crisis or tightening of global credit markets said to have commenced in the second half of 2007 and the alleged near insolvency of the group in early 2008.

The plaintiff also alleged that the product disclosure statements were misleading or deceptive in that:

- they failed to disclose the adverse matters (set out above);
- they failed to disclose that the Timbercorp Group was dependent on its ability to maintain and increase its borrowings and to sell assets in a timely matter so that if capital or debt markets tightened there was a real prospect that the Group would be at risk (the financing risk);
- they contained financial representations to the effect that the Timbercorp Group was sufficiently strong that investors could reasonably expect that Timbercorp Securities would continue to manage each scheme throughout its term, and that the principal risks associated with each relevant scheme were fully disclosed.

The plaintiff's misleading and deceptive conduct case also relied on representations alleged to have been made by Timbercorp Securities and Timbercorp Finance to the effect that fees paid by investors equalled or exceeded the cost of establishment and ongoing management of each scheme, and that their contributions would only be applied to fund the costs of the particular scheme in respect of which they were paid when in fact the payments were pooled. However this allegation was inconsistent with the information contained in the various product disclosure statements and also inconsistent with the plaintiff's claimed reliance on the strength of the Group.

The Judge's findings

Judd J noted that the structural risk was in the nature of an institution risk, that is, a risk that the institution which operates the managed investment scheme will collapse. He found that the institution risk or the risk that Timbercorp might fail to discharge its contractual obligations (the performance risk) was a significant risk and that although that risk was an everyday risk of all commercial transactions it was nonetheless one that ought to be specifically disclosed to a retail client under the Act. However he also found that the risk was in fact disclosed in the product disclosure statements.

The judge found that Timbercorp Securities was not required to disclose the adverse matters to potential or existing investors, and that the adverse matters did not make the information contained in the product disclosure statements misleading or deceptive. The adverse matters

were events that had no independent status as risks, let alone significant risks, and they did not require disclosure:

> '... because they were events of a kind that management is required to grapple with on a day to day basis. The range of such events confronting businesses is difficult to define. It will depend on the nature of the business, the business model and many other factors. Such events might include the loss of key employees, customers or suppliers; currency and interest rate changes; product and raw material price changes; for primary production industries, drought and flood; the risks of fire, regulatory change, industrial accident and patent challenges. The list could go on.'

Further, information about the adverse matters, insofar as the event occurred, was not information that a retail client would reasonably require nor would it be information that it would be reasonable for a person considering whether to acquire the product to expect to find in the product disclosure statement.

The case did not concern the continuing disclosure obligations of Timbercorp, as a listed entity, under Chapter 6CA *Corporations Act*. However the Judge noted that even pursuant to those obligations, Timbercorp Securities was not under an obligation to inform investors in the schemes of an event (such as one of the adverse matters) unless and until management realised that the event may not be capable of successful management so that they may not be able to avoid the crystallisation of the risk that the company might fail to discharge its contractual obligations due to financial incapacity.

As to the cash flow or financing risk, the defendants established that the banks had continued to support the Group until well after the last product disclosure statement was issued, and all adverse matters had occurred. Only information that is actually known, that is, of which the relevant persons have actual knowledge, must be included in a product disclosure statement. The board were not aware of any risk to cash flow until December 2008 (after the issue of the last PDS), as it was not until then that continuing bank support became uncertain, so this was a complete answer to the cash flow risk case.

His Honour noted that the risk of business failure of a responsible entity for a managed investment scheme was anticipated by the legislature when enacting the regime under the *Corporations Act* to regulate managed investment schemes. That regime requires that the responsible entity of a registered managed investment scheme must be a public company and must hold an Australian Financial Services Licence (AFSL) authorising it to operate a managed investment scheme. As a public company, the responsible entity must prepare and file financial reports for each financial year, and must appoint an auditor who conducts an audit of the financial report in accordance with the *Corporations Act*. In addition, conditions imposed on an AFSL held by a responsible entity are plainly designed to ensure that the custodian of scheme property and other assets has a minimum net tangible worth to protect the value of the scheme and thus the investments by members of the public. Other duties that also form part of the statutory regime are designed to mitigate the risk that the institution which operates the scheme will collapse. For example, a compliance plan must be prepared and applied, scheme property is to be clearly identified and held separately and ASIC is authorised to check whether the responsible entity complied with the constitution, compliance plan and the Act. Further, there must be an auditor of the compliance plan who must audit compliance with the plan on an annual basis.

Having regard to all of these considerations, His Honour held that it would not be reasonable for a retail client, when considering whether to invest in a scheme, and having been informed of the risk that the company might fail to discharge its contractual obligations due to financial incapacity, to expect to find the detailed financial data and other information required to be published and disclosed, and normally included in the annual report of the institution, to be found in the product disclosure statement as well, when it was not specifically required to be in there under Section 1013D. The annual reports of Timbercorp, its consolidated accounts, the director's report and the auditor's report were published 'to the ASX and the world'. They described and contained information about the Group business model, cash flows, debt levels, debt and finance instruments, assets, assets sales, strategic changes, adverse events including the tax announcement, the emerging credit crisis, the going concern issues, the operating income and working capital positions and other information that would inform an investor, should the investor be interested. There was no need to publish that information in the product disclosure statements as well.

The financial representations to the effect that the Timbercorp Group was sufficiently strong that investors could reasonably expect that Timbercorp Securities would continue to manage each scheme throughout its term were representations about how things would be in the future (and so would not be misleading or deceptive if made on reasonable grounds). The Judge found that Timbercorp established that they had reasonable grounds for their expressions of confidence in the group's viability and strength, which consequently were not misleading or deceptive.

In the pleaded case, the plaintiff alleged that Timbercorp Securities had breached its obligation to give priority to member's interests as required by section 601FC(1)(c) of the *Corporations Act* and a breach by the directors of an alleged duty under section 601FD to inform members of matters (such as Timbercorp's cash flow, solvency and its capacity to operate the schemes to completion) known to them that would reasonably be expected to affect the group materially. His Honour noted that the plaintiff did not seem to rely upon those causes of action in his final submissions, but found that found that the disclosure regime within the Act is a complete one, stating:

> 'One important element of the regulatory regime is a detailed scheme requiring disclosure of prescribed information to be included within a product disclosure statement and on a continuing basis. There are exclusions and exemptions from disclosure. In my opinion it would be wholly inappropriate to graft on to the obligation to give priority to the interests of members or the duties of officers of the responsible entity, specific obligations of disclosure not required by the specific provisions of the Act.'

Reliance

His Honour followed the decision in *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* [2008] NSWCA 206 that the approach to causation in respect of claims for misleading or deceptive conduct under the relevant provisions of the *Corporations Act* should be the same as under the *Trade Practices Act* 1974 (now the *Competition and Consumer Act* 2010). That is, a plaintiff relying on a contravention must establish that he relied on the misleading or deceptive conduct, or the false or misleading statement, or that he would have acted differently if the material omission had been disclosed.

In this case, on the evidence, the judge was not persuaded that the plaintiff read any of the product disclosure statements in any detail before making his decision to invest and found that the content and detail of each product disclosure statement was not an actuating factor in the plaintiff's decision making process. His Honour referred to the scepticism expressed by Spigelman CJ in *Gardiner v Agricultural and Rural Finance* [2007] NSWCA 235 about ex post facto protestations of reliance on financial representations with an investment in a tax driven scheme noting that, while each case must be assessed on its own facts, the evidence advanced by the plaintiff was such as to excite like scepticism.

Observations

As set out above, the *Corporations Act* requires that a product disclosure statement must disclose information about any significant risks associated with holding the financial product. The amount of information required is that which a person would reasonably require for the purpose of making a decision, as a retail client, whether to acquire the financial product.

The judgment contains some useful guidance to those drafting product disclosure statements for managed investment schemes.

First, the judgment confirms that the legislative provisions applicable to product disclosure statements do not require disclosure of information concerning any and all possible risks. Nor do they impose a requirement of due diligence - only information that is actually known, that is, of which the relevant persons have actual knowledge, must be included.

The Act does not define what is meant by a 'significant risk'. The judge found that the risks must be real in the sense that there is a probability of their occurrence and a consequence that is measurably significant. However the degree of probability of occurrence and the level of possible consequence are to be adjusted by reference to what a retail client would reasonably require to make a decision, and what would not be reasonable for such a person to expect to find in the product disclosure statement. Both factors are important in determining if a risk needs to be disclosed in a product disclosure statement.

The risk that the institution which operates the managed investment scheme might collapse or, put another way, the risk that that institution might fail to discharge its contractual obligations is a significant risk. Although that risk is an everyday risk of all commercial transactions, it is nonetheless one that ought to be disclosed specifically to a retail client, at least in a product disclosure statement relating to a managed investment scheme.

However, having regard to the requirements of the regime under the *Corporations Act* to regulate managed investment schemes, where detailed financial and other information that is generally available as a consequence of that regime, there is no need to publish that further detailed information in the product disclosure statement as well.

Finally, the disclosure regime within the Act is a complete one. It prescribes what must be included in a product disclosure statement and what need not. It would be inappropriate to graft further obligations of disclosure not required by the specific provisions of the Act on to other statutory obligations, such as the obligation to give priority to member's interests under section 601FC and the duties of officers owed under section 601FD.

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