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OCTOBER 2013

THE *TIMBERCORP* CLASS ACTION APPEAL: PRODUCT DISCLOSURE STATEMENT OBLIGATIONS AND MISLEADING CONDUCT IN AUSTRALIA

The *Timbercorp* class action dealt with claims based on non-disclosure contrary to the requirements for a Product Disclosure Statement ("PDS") and misleading disclosure in the context of lost investments in managed investment schemes ("MISs").

The claims under the PDS regime of the *Corporations Act*, while relatively new, have started to become common in financial product litigation.[1] The Court of Appeal examined some of the key provisions and provided guidance on the operation of the regime. The plaintiff was unsuccessful in these claims. The misleading conduct claims, although a staple of litigation in Australia because of the broad application of the prohibitions, still require proof of reliance which was found to be missing here.

CASE OVERVIEW

The Timbercorp Group was in the business of operating horticultural and forestry MISs. It invested in excess of A$2 billion on behalf of about 18,500 investors. In 2009, the Timbercorp Group was placed into liquidation, leading to the majority of MISs being of limited or no value.

A group proceeding pursuant to Part 4A of the *Supreme Court Act 1986* (Vic) was commenced on behalf of those who invested in the MISs. The representative party was Mr Woodcroft-Brown. The defendants to the proceeding were Timbercorp Securities Ltd (responsible entity for the MISs), Timbercorp Finance Pty Ltd (which made loans to investors so they could invest in the MISs) and the three persons who, at the relevant times, were directors of Timbercorp Securities—Timbercorp Finance and Timbercorp Ltd (the holding company of the Timbercorp Group) (the "Directors").

The claims made in the proceedings were:

- Timbercorp Securities failed to disclose in its PDSs information about significant risks, or risks that might have had a material influence on the decision to invest, in breach of its disclosure obligations under ss 1013D or 1013E of the *Corporations Act 2001* (Cth);

- The PDSs given to investors contained false or misleading statements; and

- Declarations made by the Directors in two scheme financial reports were false or misleading.

On appeal, 14 grounds of appeal were put forward along with a number of notices of contentions from the defendants. This *Commentary* focuses on key questions of law that were determined by the Court of Appeal.

FAILURE TO DISCLOSE RISKS

The risks which the plaintiff alleged ought to have been disclosed were referred to as the "structural risk" and the "adverse matters".

The structural risk was pleaded as a risk that the group might fail because of insufficient cash, with a consequential risk to the viability of the schemes managed by Timbercorp Securities. The factors upon which the cash flow of the group depended included:

- A failure by other project members to make project contributions to Timbercorp Securities or to repay loans to Timbercorp Finance;

- The capacity of the Timbercorp Group to obtain and/or service external funding; and

- The availability to the Timbercorp Group of securitisation of loans.

The adverse matters were matters alleged to have put the business of the group at a heightened risk of failure. The two adverse matters principally relied upon were the Australian Taxation Office's ruling that would mean that investors in non-forestry MISs would no longer be able to claim upfront deductions for contributions to an MIS (the "tax announcement") and the global financial crisis ("GFC") and its resulting impact on the availability of credit. Other adverse matters were the near insolvency of the group in 2008 and the breach of the group's loan covenants.

The structural risks and adverse matters were found by the trial judge to either have been disclosed or to not require disclosure.[2]

STATUTORY CONSTRUCTION OF THE PDS REGIME

The trial judge's findings in relation to the contravention of the PDS requirements turned on both legal interpretations and factual findings. The legal interpretations included construing the PDS provisions in the *Corporations Act* contained at sections 1013D (disclosure of significant risks), 1013E (disclosure of information that might materially influence decision-making), 1013C(2) (the need for actual knowledge prior to the requirements for disclosure applying) and 1013F (exception to disclosure based on not being reasonable for a retail client to expect disclosure in the PDS).

Sections 1013D and 1013E provide:

> Sect 1013D Product Disclosure Statement content – main requirements
>
> (1) ... a Product Disclosure Statement must include the following statements, and such of the following information as a person would reasonably require for the purpose of making a decision, as a retail client, whether to acquire the financial product:
>
> ...
>
> (c) information about any significant risks associated with holding the product ...
>
> Sect 1013E General obligation to include other information that might influence a decision to acquire.

> ... a Product Disclosure Statement must also contain any other information that might reasonably be expected to have a material influence on the decision of a reasonable person, as a retail client, whether to acquire the product.

Significant Risk. The Court of Appeal endorsed the trial judge's approach of taking into account the elements of probability, consequence and the perspective of the investor. The trial judge recognised that the risk must be significant to the investor in making a decision. Significant risk involves both probability and consequence. "Significant" means important or notable, and "risk" means exposure to chance of hazard or loss.[3]

The Court of Appeal stated that it would constitute an incorrect approach to look only at consequence when the very definition of "risk" involves the notion of chance, meaning probability. Placing undue emphasis upon consequence without probability would lead to an inappropriate focus on "significance" (to the investor) and inadequate attention to "risk".[4] Moreover, the section does not apply to "ordinary, run of the mill risks".[5]

Material Influence. Information about the "adverse matters" referred to above were said to have required disclosure based on them having a material influence on a retail client's investment decision. The trial judge disagreed but also found the adverse matters were successfully managed. Disclosure of events that may be or have been successfully managed is not necessary because the real risk has not yet "crystallised". Requiring that such information be disclosed was said to be unrealistic and oppressive.

The ground of appeal addressing the meaning and effect of s 1013E was abandoned.[6] However, the finding that management of risks can mean they are not material was the subject of a ground of appeal. The Court of Appeal endorsed the trial judge's approach.

Publicly Available Information. To give effect to the exception in s 1013F— that information does not need be included in a PDS if it is not reasonable for a retail client to expect to find the information in the PDS—the trial judge had made reference to information that was required to be disclosed by Timbercorp Limited pursuant to Part 2M of the *Corporations Act* (annual reports) and pursuant to ss 674 and 675 of the *Corporations Act* (continuous disclosure). This information was publicly available through the Timbercorp website and announcements published on the Australian Securities Exchange or Australian Securities and Investments Commission websites. The Court of Appeal found no error in considering the availability of information in the public domain for the purposes of the exception in s 1013F.

MISLEADING CONDUCT

Section 1022A of the *Corporations Act* defines a disclosure document or statement (which includes a PDS) as "defective" if, inter alia, it contains a misleading or deceptive statement. Reliance was also placed on s 1041H of the *Corporations Act*, s 12DA of the *Australian Securities and Investments Commission Act 2001* (Cth) and s 9 of the Fair Trading Act 1999 (Vic).

The plaintiff alleged that the Timbercorp Group had made two types of false or misleading representations. The first was that the group was, financially, sufficiently strong that investors would reasonably expect the MISs to be managed for the foreseeable future and that the principal risks associated with the relevant MISs were fully disclosed. The second was that scheme contributions equalled or exceeded the cost of establishing and managing a scheme, in that investors' payments would be "quarantined" and applied only to their relevant MIS, and MIS contributions would be sufficient to fund the relevant MIS. The trial judge found neither of the types of alleged misleading representation were made out.

THE IMPORTANCE OF RELIANCE TO SUCCEED ON ALLEGATIONS OF MISLEADING CONDUCT

To recover damages for misleading conduct pursuant to s 1022B(2)(c) or s 1041I(1) for breach of s 1022A or s 1041H respectively, a plaintiff "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";[7] that is, the vice aimed at by the legislation "is not issuing misleading prospectuses, but misleading investors by issuing misleading prospectuses".[8]

The case advanced by the plaintiffs required them to establish that the alleged representations constituted a decisive consideration in the decision to invest in the Timbercorp scheme.

The plaintiffs sought to prove reliance through the witness statements of the representative party and Mr Van Hoff, who was a group member. As a fall-back position, the plaintiffs argued that the financial advisers who had recommended the investments relied upon the representations.

The trial judge found the witness statements to be formulaic recitals of the pleadings. Consequently greater reliance was placed on cross-examination of the witnesses which revealed that both had only had a limited opportunity to read the PDS and had chosen the schemes on the basis that they would reduce their tax liability. Indeed the representative party had completed the necessary forms and considered at least two other schemes with his financial adviser in a meeting of one-and-a-half to two hours on one occasion, and on another occasion entered into another scheme after discussing five different schemes with his financial advisor during a two-hour meeting.[9] The trial judge found that neither witness invested in the schemes on the basis of the PDS that accompanied the schemes. The Court of Appeal found no error by the trial judge.

The plaintiff's fall-back position, although the financial advisers did not give evidence, was that it should be assumed that the advisers had carefully read the PDSs, relied upon the representations and relayed the beliefs that they so formed to the witnesses, who were induced by that advice to invest in each scheme. The Court of Appeal declined to make the above series of assumptions, which without evidence were said to lie in the realm of speculation.

This analysis highlights a key difference between shareholder class actions and financial advice/product class actions such as *Timbercorp*. In a shareholder class action, the need for actual reliance has been challenged by plaintiffs who contend that causation is able to be proven by indirect reliance. The argument proceeds on the basis that group members should be able to prove causation simply by showing the corporate defendant engaged in misleading or deceptive conduct, that such conduct caused the market price of the defendant's shares to be inflated, and that by purchasing shares at an inflated price on the market, the group members incur loss. The approach is similar to the US fraud on the market doctrine which, based on the efficient market hypothesis, states that plaintiffs are entitled to a presumption of reliance that the market for the securities in question are efficient and that the plaintiffs traded in reliance on the integrity of the market price for those securities.[10]

Although the position in Australia is unsettled, the shareholder class action may provide for a "short cut" in proving reliance where securities are traded on an active market that is not available in financial advice/product class actions.

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ENDNOTES

1 See e.g. *Stoyef v Masu Financial Management Pty Ltd* [2008] FCA 897 and *Jameson v Professional Investment Services Pty Ltd* [2009] NSWCA 28.

2 *Woodcroft-Brown v Timbercorp Securities Ltd* [2013] VSCA 284 at [37]-[57].

3 *Woodcroft-Brown v Timbercorp Securities Ltd* [2013] VSCA 284 at [130]-[131].

4 *Woodcroft-Brown v Timbercorp Securities Ltd* Ltd [2013] VSCA 284 at [131].

5 *Woodcroft-Brown v Timbercorp Securities Ltd* [2013] VSCA 284 at [139].

6 *Woodcroft-Brown v Timbercorp Securities Ltd* [2013] VSCA 284 at [142]-[143].

7 *Woodcroft-Brown v Timbercorp Securities Ltd* [2013] VSCA 284 at [227], citing *Gardiner v Agricultural and Rural Finance Pty Ltd* [2007] NSWCA 235 at [142] (Handley AJA).

8 *Woodcroft-Brown v Timbercorp Securities Ltd* [2013] VSCA 284 at [227], citing *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* (2008) 73 NSWLR 653 at 664 (Giles JA).

9 *Woodcroft-Brown v Timbercorp Securities Ltd* [2013] VSCA 284 at [230], [232].

10 John Emmerig, "Causation and Damages issues in shareholder class actions", UNSW CLE Seminar - Class Actions, Sydney, 25 October 2012.