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Civil Liability for Misstatements in Offer Documents: Striking the Right Balance

Joanna Khoo

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CIVIL LIABILITY FOR MISSTATEMENTS IN OFFER DOCUMENTS: STRIKING THE RIGHT BALANCE

Joanna Khoo

ABSTRACT

In recent times, increased scrutiny has been placed on information in financial products provided to the public. As financial products are not physical goods, members of the public must read offer documents in order to assess the financial product. The accuracy of these offer documents therefore becomes crucial.

This Article conducts a comparative analysis of the imposition of civil liability for misstatements in offer documents in the United Kingdom, Australia, and New Zealand—the objective being to determine whether the statutory regime in each of the countries effectively provides an adequate level of investor protection. In the process, a number of design issues are identified and some suggestions are made as to how those issues could be addressed.

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I. INTRODUCTION

In the wake of the global financial crisis and its uncertain aftermath, increased scrutiny is being placed on the information the public receives about financial products. To provide the right level of investor protection, a delicate balance must exist between the marketing of a financial product and the requirement to provide objective information to potential investors.

Financial products are different from other products usually purchased by consumers in that investors in financial products are not able to physically see what they have purchased. Instead, investors are offered documents to determine if a given product meets their needs. Investors, as the term suggests, invest in financial products with an expectation of a return. When the expected return is not realized, however, investors may not necessarily be able to return the product in the way that consumers can return faulty tangible goods.

In order to ensure that investors are not misled into purchasing a faulty financial product, securities laws and regulations have been developed to ensure that statements made by issuers of securities are true and do not mislead investors, either by including misstatements or by leaving out important information.¹ Sanctions for misstatements are imposed on a range of people involved in producing offer documents. These sanctions are available not only for common law misrepresentations, but also for broader problems.

Protections for the investor, however, must be balanced with the needs and incentives of the issuer. The severity of sanctions has to be balanced with ensuring that issuers are not unduly restricted in their conduct, as excessive regulation and sanctions could result in less informative and timely disclosure. This can drive issuers away from capital markets offerings and toward other financing alternatives, since conforming with regulations costs issuers money and time, which can make the endeavour less profitable, and thus less likely to be engaged in.² This in turn may result in fewer available investor choices, or even adverse selection because high quality issuers typically have a wide range of financing options available to them. A stringent civil liability

1. Jonathan Lindroos & Gordon Walker, *A Short History of Securities Regulation in New Zealand*, in *SECURITIES REGULATION IN AUSTRALIA AND NEW ZEALAND* 59–89 (Gordon Walker & Brent Fisse eds., 1994).

2. EILÍS FERRAN, *PRINCIPLES OF CORPORATE FINANCE LAW* 62 (2008) [hereinafter FERRAN, *PRINCIPLES*].

regime could also lead to excessive litigation, which is not welcome in many countries outside the United States.³

Two factors are vital to an effective civil liability regime: (1) the design of the legislative provisions that impose liability and (2) the stringency of the regulatory authority that enforces those provisions. The standard needed to reach a finding of liability is difficult to define and complicates the second prong of an effective civil liability regime.

This Article compares the imposition of civil liability for misstatements in offer documents in the United Kingdom, Australia, and New Zealand. In the last decade, all three jurisdictions have reviewed and amended their securities legislation. The objective here is to determine whether the statutory regime in each of the countries effectively addresses the two vital factors and provides an adequate level of investor protection. In the process, a number of design issues and possible solutions will be identified.

Part Two of this Article provides an overview of the general requirements for disclosure and compares the requirements for imposing civil liability for misstatements in offer documents in each jurisdiction. It also discusses two issues in imposing civil liability: (1) the relevance of materiality, causation, and reliance and (2) the imposition of liability on the secondary market. Part Three of this Article compares persons that are held liable for misstatements in each jurisdiction, with particular emphasis on the liability of issuers and directors. Part Four considers whether the enforcement procedures in each of the jurisdictions work effectively to adequately police misstatements and to provide sufficient investor protection.

Note that the legislation in all three jurisdictions distinguishes between omissions and inclusions. This is consistent with *New Brunswick & Canada Railway Co v. Muggeridge*, an early common law decision on liability for misstatements in prospectuses.⁴ Where the term “misstatement” is used in this Article, it broadly refers to both positive inclusions and omissions in offer documents. While the focus of this Article is on liability under securities legislation, relief also exists for investors outside the securities regime, such as under the torts of deceit or negligent misstatement, or under appropriate fair trading or trade

3. Peter Fitzsimons, “If the Truth be Known”: *The Securities Act 1978 and Directors’ Liability for Misstatements in a Prospectus (Part II)* 6 N.Z. BUS. L.Q. 235, 256 (2000); see also Eilís Ferran, *Are US-Style Investor Suits Coming to the UK?*, Civil Enforcement in Securities Law Conference, Cambridge (2009) [hereinafter Ferran, *US-Style Investor*], available at <http://ssrn.com/abstract=1436333>.

4. (1860) 1 Dr. & Sm. 363 (U.K.).

practices legislation. These remedies are not considered in this Article.⁵

II. THE GENERAL REQUIREMENT FOR DISCLOSURE AND THE IMPOSITION OF CIVIL LIABILITY FOR MISSTATEMENTS

An analysis of liability for misstatements in offer documents begins with the requirement of disclosure. Justice Brandeis famously said, “sunlight . . . is the best of disinfectants.”⁶ This mantra is often cited by disclosure proponents, and mandatory disclosure is now an entrenched viewpoint around the world in securities legislation.⁷ Disclosure-based regulation is widely regarded as the optimal policy, especially in developed securities markets such as the three analysed in this Article.⁸

As the requirement to disclose information is necessarily linked to liability for misstatements made in the course of that disclosure, this Section discusses these two topics together for each of the three jurisdictions. A comparison and critique is then made of the treatment in each of the jurisdictions of these two topics.

A. United Kingdom

(1) General requirement for disclosure

The requirement to fully disclose information when selling securities to the public developed in the late 19th century, when burgeoning industrial and speculative activity led to the advent of unscrupulous promoters selling securities on false grounds or without providing full facts.⁹ In response, the courts developed rules to ensure that persons who invite the public to purchase securities are “bound to state everything with strict and scrupulous accuracy”¹⁰ and with “the utmost candour and honesty.”¹¹

5. Note that in New Zealand the fair trading legislation is subjugated to securities regulation in any case. See §63A of the New Zealand Securities Act (1978) and §19 of the Securities Markets Act (1988) (N.Z.).

6. LOUIS BRANDEIS, *OTHER PEOPLE'S MONEY: AND HOW THE BANKERS USE IT* 62 (1933).

7. John C. Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 721–23 (1984); see also Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1339 (1999).

8. S. M. Solaiman, *Disclosure Philosophy for Investor Protection in Securities Markets: Does One Size Fit All?*, 28(5) COMP. LAW. 135 (2007).

9. Peter Fitzsimons, “*If the Truth be Known*”: *The Securities Act 1978 and Directors' Liability for Misstatements in a Prospectus*, 5 N.Z. BUS. L.Q. 164, 165 (1999).

10. *New Brunswick & Canada Ry. Co v. Muggeridge*, (1860) 1 Dr. & Sm. 363, 381 (U.K.).

11. *Central Ry. Co of Venezuela v. Kisch*, (1867) L.R. 2 H.L. 99, 113 (U.K.).

In terms of liability for breach of disclosure obligations, the common law starting point is *Derry v. Peek*, in which the directors of a company seeking to raise capital made an honest but unreasonable statement in a prospectus that the company had authority to use steam power for its carriages.¹² In fact, the authorization was conditioned on consent, and that consent was subsequently denied. The House of Lords held that the directors were not liable for damages as there was no proof of fraud—an honest belief on their part, though unreasonable, was insufficient for liability to attach as long as it did not reach the level of recklessness.¹³

The case left a gap in investor protection for non-deceitful statements, which almost immediately led to statutory intervention in the United Kingdom. The Directors Liability Act of 1890 imposed liability for untrue statements in a prospectus, even if those statements were made in a careless belief that they were true.¹⁴ The underlying philosophy was that investors should be provided with sufficient information in order to enable them to make informed decisions, thereby protecting investors and preventing fraudulent enterprises.¹⁵ This early legislation effectively shifted the onus of proof under the common law of tort at that time.¹⁶

Today, liability for misstatements in offer documents in the United Kingdom is governed by the Financial Services and Markets Act of 2000 (U.K. Act). Sections 80 and 87A of the U.K. Act contain the general duty of disclosure in relation to listing particulars and prospectuses, respectively.¹⁷ For present purposes, it is sufficient to deal with the duty of disclosure with respect to prospectuses, which continue to be the principal means by which information is provided to investors.¹⁸

Section 87A of the U.K. Act provides that prospectuses submitted to the Financial Services Authority (UKFSA) must contain the “necessary

12. (1889) L.R. 14 App. Cas. 337 (H.L.).

13. PAUL L. DAVIES, *GOWER'S PRINCIPLES OF MODERN COMPANY LAW* 429 (6th ed., 1997).

14. PHILIP MITCHELL, *TOLLEY'S DIRECTOR'S DUTIES* 302 (2007).

15. DAVEY COMMITTEE, 1895, C. 7779, paras. 6, 28, *quoted in* ROMAN TOMASIC & STEPHEN BOTTOMLEY, *CORPORATIONS LAW IN AUSTRALIA* 556 (1995) and *SECURITIES REGULATION IN AUSTRALIA AND NEW ZEALAND* 67 (Gordon Walker & Brent Fisse eds., 1994).

16. ALASTAIR HUDSON, *SECURITIES LAW* 584 (2008). It also marks the birth of the prospectus and forms the genesis of the core company laws today.

17. Broadly, a prospectus must be submitted with respect to securities which are to be offered to the public in the United Kingdom for the first time before admission, and listing particulars are required to be submitted in all other cases where the securities are being listed. *See* JONATHAN FISHER ET AL., *THE LAW OF INVESTOR PROTECTION* 124–25 (2003).

18. Section 81 of the U.K. Act provides that listing particulars are required to “contain all such information as investors and their professional advisers would reasonably require, and reasonably expect to find there, for the purpose of making an informed assessment” of the securities. This is a narrower requirement than that under section 87A, which makes no reference to professional advisers who would presumably possess greater financial knowledge and therefore require less information.

information.”¹⁹ The “necessary information” is that “information necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer . . . and the rights attaching to the securities.”²⁰ This approach can be described as part prescriptive and part principle-based. While the legislation does not prescribe the exact information that is required to be included in the prospectus, reference to the issuer’s assets, liabilities, and financial position provides some context for the information that must be included.

Only prospectuses that are being submitted to the UKFSA, which are for securities that are to be admitted to the official list or for trading on a regulated market, are required to comply with section 87A of the U.K. Act.²¹ Prospectuses for all other securities are governed by common law,²² which, as discussed above, requires disclosure of all relevant information.²³

(2) Imposition of civil liability for misstatements

Section 90 of the U.K. Act imposes liability for misstatements or defects in a prospectus. As with section 87A of the U.K. Act, section 90 applies only to a prospectus for securities that is to be admitted to the official list or for trading on a regulated market. Section 90(1), as amended by the Prospectus Regulations 2005 (amendments in brackets),²⁴ provides:

Any person responsible for listing particulars [or a prospectus] is liable to pay compensation to a person who has:

- a) acquired securities to which the particulars apply [or acquired transferable securities to which the prospectus applies]; and
- b) suffered loss in respect of them as a result of—
 - (i) any untrue or misleading statement in the particulars [or the prospectus]; or
 - (ii) the omission from the particulars [or the prospectus] of any matter required to be included by section 80 or 81 [or, in

19. Financial Services and Markets Act, § 87A(1)(b) (2000) (U.K.).

20. *Id.* § 87A(2).

21. HUDSON, *supra* note 16, at 347.

22. *Id.*

23. *See supra* notes 10 & 11 and accompanying text.

24. Prospectus Regulations 2005, § 6.

respect of prospectuses, section 87A or 87G].²⁵

Section 90 of the U.K. Act therefore links an investor who has suffered a loss with the persons that are responsible for the preparation of offer documents, which under common law is not necessarily easy to prove, especially between arm's length parties.²⁶ This issue is discussed in further detail below.²⁷

B. Australia

(1) General requirement for disclosure

Australia has a federal constitution, pursuant to which the central Commonwealth legislature and the six state legislatures have the power to make law on only a limited range of matters.²⁸ Until the early 2000s Australia had a wholly state-based regulatory framework and did not have comprehensive national legislation for the securities industry.²⁹ Instead, the various states passed their own legislation, but in a uniform fashion.³⁰

Reform of Australian securities regulation began in the late 1990s, after the Corporate Law Economic Reform Program (CLERP) conducted a review. The CLERP proposals culminated in the passing of the Corporations Act in 2001 (Aust. Act).³¹ The Aust. Act governs three types of disclosure documents: a prospectus, a profile statement, and an offer information statement.³²

The Aust. Act prescribes different levels of disclosure for different types of disclosure documents. For example, in relation to a full prospectus, section 710 of the Aust. Act requires the disclosure of "all the information that investors and their professional advisers would

25. Words in brackets denote amendments made by the Prospectus Regulations 2005.

26. HUDSON, *supra* note 16, at 572–73. Note, however, that *Possfund Custodian Trustee Ltd v. Diamond* [1996] 2 All. E.R. 774 may have changed this.

27. See *infra* note 54 and accompanying text.

28. ROBERT BAXT, CHRISTOPHER MAXWELL, & SELWYN BAJADA, *STOCK MARKETS AND THE SECURITIES INDUSTRY: LAW AND PRACTICE* 4 (3rd ed., 1989).

29. ROBERT BAXT, ASHLEY BLACK, & PAMELA HANRAHAN, *SECURITIES AND FINANCIAL SERVICES LAW* 30 (7th ed., 2008).

30. MARC STEINBERG, *INTERNATIONAL SECURITIES LAW: A CONTEMPORARY AND COMPARATIVE ANALYSIS* 23 (1999).

31. BAXT, BLACK, & HANRAHAN, *supra* note 29, at 47.

32. Corporations Act, § 9 (2001) (Austl.).

reasonably require to make an informed assessment” of the securities.³³ This is an example of the principle-based approach, as issuers are left to determine, based on principle rather than a prescribed list, what information is reasonably required.

(2) Imposition of civil liability for misstatements

In Australia, liability can be imposed with respect to disclosure documents, regardless of which type of disclosure document is at issue. Section 728 of the Aust. Act provides:

A person must not offer securities under a disclosure document if there is:

- a) a misleading or deceptive statement in:
 - i. the disclosure document; . . .
- b) an omission from the disclosure document of material required by section 710, 711, 712, 713, 714 or 715; or
- c) a new circumstance that:
 - i. has arisen since the disclosure document was lodged; and
 - ii. would have been required by section 710, 711, 712, 713, 714 or 715 to be included in the disclosure document if it had arisen before the disclosure document was lodged.³⁴

Civil liability is imposed under section 729 by providing that:

A person who suffers loss or damage because an offer of securities under a disclosure document contravenes subsection 728(1) may recover the amount of the loss or damage from a person referred to in the following table if the loss or damage is one that the table makes the person liable for. This is so even if the person did not commit, and was not involved in, the contravention.³⁵

The relevant components of civil liability for misstatements under

33. BAXT, BLACK & HANRAHAN, *supra* note 29, at 166.

34. Corporations Act, § 728(1) (2001) (Austl.).

35. *Id.* § 729(1).

the Aust. Act are discussed in further detail below.³⁶

C. New Zealand

(1) General requirement for disclosure

In its early stages, New Zealand's regulation of securities was largely characterized by what has been termed the "uncritical adoption of United Kingdom legislation."³⁷ This lasted for more than half a century, until 1955, when the Companies Act 1955 increased the amount of information required to be disclosed in a prospectus.³⁸ For the next twenty or so years, New Zealand's legislation was piecemeal and took a reactive stance towards raising capital.³⁹

The catalyst for reform of New Zealand's securities regulation came in the 1970s, when there were various financial collapses, most notably the collapse of Securitibank.⁴⁰ The New Zealand Securities Act of 1978 (N.Z. Act) prohibits offering securities to the public unless the offer is made by way of a prospectus or an investment statement.⁴¹ The regulation of securities in New Zealand was previously entity-based, and the N.Z. Act therefore marked a reversal in New Zealand securities law.⁴²

The N.Z. Act, together with the Securities Regulations 1983, prescribes the information that must be disclosed.⁴³ For investment statements, the information answers key questions ranging from "What sort of investment is this?" to "What are my risks?"⁴⁴ The legislation is therefore prescriptive in its approach. This prescriptive approach is supplemented by the requirement for directors to state in the prospectus that there are no material matters other than those already disclosed.⁴⁵

An extensive review of New Zealand's securities legislation began in

36. See *infra* note 53 and accompanying text.

37. Lindroos & Walker, *supra* note 1, at 59–89, 60.

38. *Id.* at 59–89, 68.

39. *Id.* at 59–89, 59, 68.

40. *Id.* at 59–89, 71–72.

41. New Zealand Securities Act, § 33 (1978). There is also the ability to make an offer pursuant to an advertisement that is not an investment statement.

42. Cathy Quinn & Peter Ratner, *Introduction to New Zealand Securities Law*, in CHARLES MORISON, MORISON'S COMPANY AND SECURITIES LAW (LexisNexis 2004 reissue).

43. In effect, the N.Z. Act only came into force in 1983, when the Securities Regulations 1983 was introduced.

44. Securities Regulations 1983 (N.Z.), sched. 3D.

45. *Id.* sched. 1, clause 40. In practice, investors do not read or review prospectuses but rely mainly on the investment statement.

2002. This brought about the introduction of new securities legislation and regulations and the amendment of the existing securities legislation, including the N.Z. Act.⁴⁶ These amendments increased the size and range of penalties and remedies available and gave greater flexibility to the New Zealand Securities Commission (NZSC). The New Zealand securities regulations continue to be reviewed on an ongoing basis.

(2) Imposition of civil liability for misstatements

Civil liability for misstatements in offer documents is imposed under the N.Z. Act when there is a “civil liability event” that includes the distribution of an advertisement or a registered prospectus that contains an untrue statement.⁴⁷ An “advertisement” is specifically defined to include an investment statement,⁴⁸ which, being specifically designed for laypersons, is the document most often read by investors.

Section 55(a) of the N.Z. Act deems a statement to be untrue if:

- (a) it is misleading in the form and context in which it is provided; or
- (b) it is misleading by reason of the omission of a particular which is material to the statement in the form and context in which it is included.

Where there is a civil liability event, the court has the ability to provide two possible remedies.⁴⁹ First, on application by the NZSC, the court may make a pecuniary penalty order and a declaration of civil liability.⁵⁰ Second, the court may, on the application of the NZSC or a subscriber, order

a liable person to pay compensation to all or any of the persons who subscribed for any securities on the faith of an advertisement or registered prospectus that includes an untrue statement, for the loss or damage that the persons have sustained by reason of the untrue statement.⁵¹

46. The Securities Markets Act 2006, the Securities Markets (Substantial Security Holders) Regulations 2007, and the Securities Markets (Investment Advisers and Brokers) Regulations 2007 were introduced, and amendments were made to the Takeovers Act, the Companies Act, the Fair Trading Act, and the N.Z. Act.

47. New Zealand Securities Act, § 55B(a) (1978).

48. *Id.* § 2A(2)(b).

49. *Id.* § 55A(1).

50. *Id.* § 55C.

51. *Id.* § 55G.

The relevant components of civil liability for misstatements in offer documents under the N.Z. Act are discussed in further detail below.⁵²

D. Comparison and Critique

In reviewing legislation imposing liability for misstatements in offer documents, two issues stand out. The first issue is the relevance of the tests of materiality, causation, and reliance, including whether each test should be used. The second issue is whether there should be liability for misstatements where securities are purchased on the secondary market (as opposed to directly from the issuer).

(1) The relevance of materiality, causation, and reliance

The materiality test can be an important element in examining misstatements even though it is not generally required by statute. The only jurisdiction that has a statutory materiality requirement is New Zealand, and even then the materiality test exists only with respect to omissions and not inclusions.⁵³ In contrast, the United Kingdom and Australia impose liability for omissions only where required matters are not included, without any reference to materiality.⁵⁴

This difference is perhaps a reflection of the principle-based approach used in the United Kingdom and Australia, as opposed to the prescriptive approach used in New Zealand. The principle-based approach relies on an assumption that the information necessary to allow investors to make informed assessments inherently includes a materiality test. Under this approach, an explicit statutory materiality requirement is not necessary. In contrast, under the prescriptive approach, the prescribed information is assumed to be material. The prescriptive approach, however, can be under-inclusive, in that information not prescribed may nevertheless be material. Thus, a specific materiality requirement is necessary to capture information that would not otherwise fall within the prescribed information.

In determining whether an omission is material, New Zealand courts focus on investor perceptions. The leading case is *Coleman v. Myers*, where Judge Cooke described the test as “those considerations which can

52. See *infra* note 53 and accompanying text.

53. This can be compared to the imposition of criminal liability in New Zealand, under which there is a defence if it is proved that the statement was immaterial. See New Zealand Securities Act, § 58 (1978).

54. See Financial Services and Markets Act (2000) (U.K.); see also Corporations Act (2001) (Austl.).

reasonably be said, in the particular case, to be likely materially to affect the mind of a vendor or of a purchaser.”⁵⁵ This suggests that while material information does not need to actually or solely determine the outcome of an investor’s decision, it must at least be information that investors would take into account in making their decision. The relevant perspective in this analysis is that of the reasonable investor, not of any actual investor.

A materiality analysis, however, must look beyond statutory provisions. Thus, while neither the U.K. Act nor the Aust. Act expressly refers to materiality, the concept is implied in the provisions and, since the Directors Liability Act 1890, has become a cornerstone of the imposition of civil liability for misstatements.⁵⁶ Common law has long held that inclusions must be material in order to be misleading or untrue.⁵⁷ Similarly, omissions must be material to render the statements misleading.⁵⁸ Some suggest, at least with respect to the U.K. Act, that materiality continues to be required for both inclusions and omissions, despite the absence of precise words to that effect.⁵⁹ This view leads to some uncertainty regarding the N.Z. Act, as it then becomes unclear whether the materiality requirement applies to inclusions, even though the statute does not so state.

The requirement of materiality under the Aust. Act is somewhat more obscure. The predecessor to the Aust. Act, the Australian Corporations Law, prohibited the issue of a prospectus if the false or misleading statement or omission was material, the statement was true, or the omission was inadvertent.⁶⁰ This applied to both civil liability and criminal liability. The Aust. Act, however, contains a materiality requirement for criminal liability only—i.e., criminal liability is imposed if the misleading or deceptive statement or omission is materially adverse to an investor.⁶¹ The difference in tests for civil liability and criminal liability would appear to indicate that the inclusion of a materiality requirement must have some effect. Yet, if the common law method is to imply a requirement of materiality in any event, it is unclear whether the

55. *Coleman v. Myers*, [1977] N.Z.L.R. 225 (N.Z.S.C. & C.A.).

56. Greg Golding, *The Reform of Misstatement Liability in Australia's Prospectus Laws*, Univ. of Sydney 148, 152 (Dec. 31, 2001), available at <http://ses.library.usyd.edu.au/handle/2123/607>.

57. See *Danneberg & Knapp P.C. v. Jarahis*, No. 99-11690 (11th Cir. July 16, 2002), available at <http://www.ca11.uscourts.gov/opinions/ops/199911690.opn.pdf>.

58. *Id.*

59. HUDSON, *supra* note 16, at 592.

60. Corporations Law, § 996 (1989) (Austl.).

61. Corporations Act, § 728(3) (2001) (Austl.).

difference in statutory tests for civil liability and criminal liability is of any significance.

Regarding the removal of the materiality requirement for civil liability, the Explanatory Memorandum to the CLERP Bill provided:⁶²

It will no longer be necessary in civil actions under the Law to establish that the misleading or deceptive statement, omission or new matter was material. . . . However in place of a materiality element, recovery of damages will depend on establishing that the loss has been suffered as a result of the misleading or deceptive statement, omission or new matter.⁶³

The shift in the test of liability from one of materiality to one of causation is somewhat curious, but certainly not novel. Beginning in the late 1800s and early 1900s, courts merged the concepts of materiality and reliance. For example, in *De La Cour v. Clinton* the court stated:

I hold this misstatement not to have been material or, in other words, that the plaintiffs have not sustained any loss or damage by reason of this untrue or inaccurate statement in the prospectus.⁶⁴

In effect, the court first objectively determines whether the misstatement is material, and if it is, the court presumes reliance unless the person responsible for the misstatement can prove otherwise.⁶⁵ In other words, a material misstatement apparently justifies an inference that the inclusion or omission influenced the person to invest.⁶⁶ This two step test appears to be used regardless of the words of the particular legislation governing the materiality of misstatements.

Such an interpretation in case law raises the question of whether it is even necessary to include a legislative requirement for materiality. Further confusion results when the concept of materiality is present in relation to omissions but not in relation to inclusions, as in New Zealand,

62. Explanatory Memorandum to CLERP Bill, para. 8.29 (1999).

63. The same implication is found in section 55F(2) of the N.Z. Act, which requires the court to have regard to all relevant matters (including, among other things, the nature and extent of the civil liability event and the damage to the integrity or reputation of New Zealand's securities markets) in determining an appropriate pecuniary penalty.

64. (1904) 20 T.L.R. 421 (U.K.).

65. *Amison v. Smith*, (1889) 41 Ch. D. 348 (C.A.) (U.K.).

66. *Smith v. Chadwick*, (1884) 9 App. Cas. 187 (H.L.) (U.K.).

or when the concept of materiality is present in relation to criminal but not civil liability, as in both Australia and New Zealand. Thus, in these uncertain circumstances a strong argument exists that statutory enactments have implicitly overruled the common law position.

If materiality is not included as a statutory test, what about causation or reliance? As set out above, the U.K. Act simply stipulates that the claimant must have suffered loss “as a result” of the misstatement. It is not clear whether this means the claimant must prove that the misleading statement caused them to invest, or whether the mere fact that there has been a misstatement is sufficient for action to be brought under section 90 of the U.K. Act.⁶⁷ If the former is required, then the test appears to morph into one of reliance. However, if the person was fully aware of the misstatement and its defective nature but nevertheless acquired the securities, then it is unlikely that the person suffered the loss “as a result of” the misstatement.⁶⁸

The U.K. Act lacks any statutory requirement that the claimant rely on the misstatement. It is generally accepted that this does not require the purchaser to have read or relied on the particular misstatement, or even to have been aware of its existence.⁶⁹ All that seems to be required is that the misstatement affects the price of the security. This standard of causation or foreseeability is not as high as the standard ordinarily required in tort. Rather, it is a weak causation requirement, i.e. the loss must be “a result of” the misleading statement. Positive non-reliance is, however, a defence to liability.⁷⁰

On its face, the Aust. Act also does not contain a statutory requirement of reliance. It simply requires a causal link between the loss or damage and the contravention of section 728.⁷¹ Nevertheless, some suggest that this seems to require proof that the claimant’s loss arose from the conduct of the person responsible, not simply proof that the misstatement would matter to a hypothetical investor.⁷² Once again, if this is accepted, then the statutory requirement for causation morphs into proof of individual reliance by the particular claimant. Australian courts have held that reliance can be inferred from the relevant circumstances⁷³

67. HUDSON, *supra* note 16, at 592.

68. *Id.* at 578–79.

69. Paul Davies, Davies Review of Issuer Liability—Liability for misstatements to the market: A discussion paper by Professor Paul Davies QC, para. 27 (Mar. 2007) (unpublished paper, on file with author).

70. Financial Services and Markets Act, sched. 10A, para. 6 (2000) (U.K.).

71. Corporations Act, § 729 (2001) (Austl.).

72. BAXT, BLACK & HANRAHAN, *supra* note 29, at 257, 334.

73. Gould v. Vaggelas, (1985) 157 C.L.R. 215 (C.A.) (Austl.).

or, in some cases, indirectly.⁷⁴

The uncertainty in the statutory tests contained in the U.K. Act and the Aust. Act is unhelpful. In comparison, the N.Z. Act is clear, albeit narrow, in its approach. Civil liability under the N.Z. Act is imposed where the claimant has subscribed for securities “on the faith of” a prospectus or advertisement that includes an untrue statement.⁷⁵ Some suggest that faith does not need to be placed on the misstatement itself but merely on the prospectus or advertisement,⁷⁶ although this contention is debatable.⁷⁷

Assuming that faith need only be placed on the document and not on the particular misstatement, the claimant must at least show that it received or saw the prospectus or advertisement prior to subscription.⁷⁸ In practice, investors seldom view registered prospectuses. However, issuers are required to provide investors with a copy of the investment statement (which is included in the definition of “advertisement”) prior to subscription of the securities, so this requirement is easily satisfied with respect to investment statements/advertisements.⁷⁹ To some extent this reveals some mismatch in the difficulty of bringing a successful claim regarding an investment statement as opposed to a prospectus.

The N.Z. Act also contains the element of causation. The claimant is required to show that the misstatement led an investor to act, resulting in loss or damage.⁸⁰ Like the U.K. Act and the Aust. Act, the test of causation seems to morph into reliance. This is discussed in more detail below.

Of the three jurisdictions, establishing civil liability seems to be the most difficult in the New Zealand system. This could be the reason that few civil proceedings are undertaken by potential claimants for misstatements in New Zealand. This conclusion is difficult to make, however, as no cases have been undertaken in the United Kingdom either. This issue is discussed in further detail below.⁸¹ Having a weak civil liability regime is not desirable, as it raises too many barriers to

74. See *Janssen-Cilag Pty Ltd. v. Pfizer Pty Ltd.*, (1992) 37 F.C.R. 526, 529–30 (Austl.); *Hampic Pty. Ltd. v. Adams*, [1999] N.S.W.C.A. 455 (Austl.); *Stockland Pty. Ltd. v. Retail Design Group Pty. Ltd.*, [2003] N.S.W.C.A. 84 (Austl.).

75. New Zealand Securities Act, § 55G (1978).

76. BROOKERS SECURITIES LAW SE55G.01 (Supp. 2009).

77. See *infra* Section II.D.a.

78. BROOKERS SECURITIES LAW SE55G.01 (Supp. 2009).

79. New Zealand Securities Act, § 2 (1978).

80. *Id.* § 55G.

81. See *infra* note 171 and accompanying text.

enforcement, thus reducing the credibility of the capital market.⁸²

In addition to the three jurisdictions discussed above, it may be beneficial to mention a fourth jurisdiction, the United States. Section 11 of the United States Securities Act of 1933⁸³ (U.S. Act) imposes liability for a registration statement that “contain[s] an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading.”⁸⁴ Similarly, section 12 of the U.S. Act imposes liability for a prospectus or oral offer for the sale of securities that contains a material misstatement or material omission.⁸⁵

The U.S. Act clearly requires materiality regardless of whether the misstatement is an inclusion or an omission.⁸⁶ Furthermore, proof of actual reliance on the material misstatement is not required.⁸⁷ Due to the strong focus on materiality in the United States, authoritative case law has developed outlining the test for materiality in securities transactions: if there is a substantial likelihood that a reasonable investor would consider the matter in question important in making the investment decision, that matter is material.⁸⁸

The different methods that the various jurisdictions have adopted in order to attach liability for misstatements boil down to one question: what is the relevance of having a materiality, reliance or causation threshold? This question is perhaps best answered as follows: some filtering device is necessary to sift the worthy cases from those that are purely opportunistic.⁸⁹

But the question remains of which filtering device creates the most appropriate balance between investor protection and issuer autonomy. The recent case of *Houghton v. Saunders* provides an example of the operation of the reliance and causation tests in New Zealand.⁹⁰

82. Angie Zandstra, Jason Harris & Anil Hargovan, *Widening the net: Accessorial liability for continuous disclosure contraventions*, 22 AUSTL. J. CORP. L. 51 (2008).

83. 15 U.S.C. § 77a (1933).

84. New Zealand Securities Act, § 11(1) (1978).

85. United States Securities Act, § 12(a)(2) (1933).

86. See generally Securities Act of 1933.

87. John H. Mathias, *Directors and Officers Liability: Prevention, Insurance and Indemnification*, LAW J. PRESS, 2000, at 3.16, 3.20.

88. *TNZSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976).

89. Krista L. Turnquist, *Note: Pleading Under Section 11 of the Securities Act of 1933*, 98 MICH. L. REV. 2395 (2000).

90. [2009] N.Z.C.C.L.R. 13 (H.C.), *aff'd*, *Houghton v. Saunders*, [2009] N.Z.C.A. 610 (C.A.).

a) Houghton v. Saunders

Houghton v. Saunders was an interlocutory appeal brought in the New Zealand High Court.⁹¹ The defendants requested the court to dismiss certain causes of action and to review and rescind orders given by the lower court. In May 2004, Feltex Carpets Limited (Feltex) sold its shares by way of initial public offering. Feltex registered a prospectus, which projected net profit after tax for the year ending June 2005 as \$23.9 million.

On March 31, 2005, less than a year after the offering, Feltex announced a downgrading of the profit forecast to \$15–\$16 million. By March 2006, the value of the shares had declined from \$1.70 per share, the initial purchase price, to \$0.60 per share. Feltex went into liquidation in December 2006, by which time all shareholder equity disappeared and creditors had claims approximating \$30–\$40 million.

An October 2007 Securities Commission inquiry found that the prospectus was not materially misleading and that the Securities Commission would not take any further action with regard to the prospectus.⁹²

Houghton initiated proceedings and represented shareholders that had purchased shares in the initial public offering (IPO Shareholders), and Jones represented shareholders that had purchased shares subsequently on the secondary market (Post-IPO Shareholders). The claims were brought against five groups of people, including the former directors of Feltex and the promoter of the IPO. The claims were for breach of the N.Z. Act (on the basis that the prospectus contained untrue statements) tortious negligence, breach of fiduciary duty, and breach of the Fair Trading Act.

The court considered the issue of reliance in relation to each of the claims. The plaintiffs accepted that the words “on the faith of” in section 56 of the N.Z. Act imported an element of actual reliance.⁹³ However, they argued that the reliance need only be placed on the registered prospectus (as opposed to the particular untrue statement in the prospectus). In response to this argument, Justice French stated:

Section 56 also specifically requires the loss or damage

91. *Id.*

92. Securities Commission *Feltex Carpets Limited – IPO Prospectus, Financial Reporting and Continuous Disclosure* (Oct. 13 2007), available at <http://www.sec-com.govt.nz/publications/documents/feltex/>.

93. Houghton, [2009] N.Z.C.C.L.R. 13, para. 114 (H.C.).

must have been sustained “by reason of the *untrue statement*.” It does not say by reason of the prospectus. On the face of it, the wording would seem necessarily to require actual reliance on the untrue statement itself.⁹⁴

Justice French also stated that in the context of section 56, “reliance bears on causation.”⁹⁵ These statements show that the test of reliance seems to morph into causation. Justice French then stated:

My conclusion on the claim under the Securities Act as pleaded is that it will require proof of actual reliance on the alleged untrue statements. This will of necessity vary from individual to individual, and means the necessary commonality of interest to justify a representative action is lacking.⁹⁶

Thus, as shown in *Houghton v. Saunders*, New Zealand—one of the weakest civil liability regimes—weighs the difficult use of actual reliance and its relationship with causation as the main filtering device to strike the right balance between investor protection and issuer autonomy. However, as described in further detail below, heavy use of the reliance factor as a filtering device for alleged untrue statements is an issue for concern.

b) Materiality and causation as the filtering device

Houghton v. Saunders demonstrates that the requirement for reliance on the untrue statement itself is an overwhelming obstacle to bringing a claim under the N.Z. Act. Offer documents are lengthy documents and often run into hundreds of pages. Despite attempts made by various jurisdictions, including Australia and New Zealand, to simplify offer documents, they remain difficult to read and understand even for

94. *Id.* at para. 115 (citing *Murray v. Morel & Co Ltd* [2007] 3 NZLR 721 at paras [89] and [107]) (citations omitted) (emphasis added). On appeal to the New Zealand Court of Appeal, Justice Baragwanath noted that while “the clause ‘all persons who subscribe for any securities on the faith of a prospectus’ may refer to reliance generally on the prospectus rather than specific passages or figures,” the courts have nevertheless narrowed the actual application of section 56 to “specific reliance” upon “specific language of the audit report and underlying accounts.” *Id.* at para. 85. He further noted that in this case, the Court of Appeal did not “propose to determine at this stage the scope of reliance required.” *Id.* at para. 86.

95. *Id.* at para. 113.

96. *Id.* at para. 119.

reasonably knowledgeable investors.⁹⁷ This difficulty is even more pronounced when the offer has a complex structure, which is not uncommon.

This subsection will analyze Justice French's discussion on actual reliance and illustrate how requiring reliance brings additional obstacles and negative impacts on the civil action process. First, requiring reliance on the untrue statement is unrealistic due to the potentially excessive length of an offer document. Second, a reliance requirement would stifle class actions and harm those investors who did suffer a loss but did not read the entire document to sufficiently rely on a particular misstatement. Third, this subsection will also show how several countries have begun to do away with the requirement of reliance because of its unrealistic requirements and harmful effects. Furthermore, this subsection will also explore the necessity and efficacy of the filtering devices of materiality and causation.

Under Justice French's analysis, it is practically impossible to bring a case using a class action. Even if a class action procedure were regulated, proof of actual reliance by each claimant would still need to exist, thereby seriously limiting the possibility of class action. Thus, Justice French's analysis ignores the operation of the capital market in practice. Furthermore, it is unrealistic to expect private individuals to expressly rely on offer documents in making decisions to invest.⁹⁸ Rather, it is more common for "the herd" to essentially free ride on the reliance of financial advisers and brokers who do read and rely on offer documents.⁹⁹ Justice French's reasoning would deny relief to all of these investors and eliminate class actions *ab initio*.

Additionally, if investors do not read an offer document, it is difficult for them to argue that they relied upon a particular untrue statement in the offer document. Reliance upon a particular statement sets an extremely high standard, as many investors would be excluded from relief even though they may have suffered loss. Their reliance may have been on the reputation of the issuer or on other representations in the offer documents that were not technically untrue. However, in such a case there is no policy reason for refusing relief.¹⁰⁰

Due to the negative effects of requiring reliance, many jurisdictions

97. Donovan W. M. Waters, *A Canadian Looks at the Investment Product and Adviser Disclosure Law*, 3 N.Z. BUS. L.Q. 160, 187 (1997).

98. *Id.*

99. *Id.* at 171.

100. See, e.g., 2 THOMAS LEE HAZEN, *TREATISE ON THE LAW OF SECURITIES REGULATION* 527 (3d ed. 1995).

have done away with the requirement. Canada, for example, amended the Ontario Securities Act in 2002 to remove the reliance requirement¹⁰¹ in response to perceived deficiencies in the common law, which required actual reliance on the misrepresentation.¹⁰² In Canada, a shareholder seeking to advance a claim need not establish that they were influenced by, or were even aware of, the misrepresentation.

Furthermore, in the United Kingdom, Australia and Canada, the courts have taken the position that where a representation is intended to induce a party to enter a contract, a presumption of reliance on the representation may arise as an inference of fact, though not as an inference of law.¹⁰³ Thus, if the reliance requirement were removed, this inference of fact would no longer be required and would assist in simplifying the law.

Removing reliance as an initial filtering device does not necessarily introduce a fraud on the market theory. The fraud on the market theory assumes that share prices in an efficient market reflect all information available about the shares, which ostensibly includes misstatements.¹⁰⁴ As shareholders rely on the integrity of the market price, reliance does not need to be proved.¹⁰⁵ This theory has so far been limited to the United States in the context of the specific regulatory context there. However, the theory has been rejected in New Zealand¹⁰⁶ and Australia.¹⁰⁷

Furthermore, it is also important to note that the discussion on removing the requirement for reliance thus far has been limited to the purchase of securities directly from the issuer through an offer document. In these cases, the link between the purchase and the loss is so strong that it is not unreasonable to presume reliance. However, whether reliance is required for secondary market purchases is a separate issue that is considered below.¹⁰⁸

Despite Justice French's analysis, fewer courts and statutes are requiring reliance to prove misrepresentation because it is a burdensome

101. Ontario Securities Act, R.S.O. ch. 5 § 130 (1990).

102. See *Carom v. Bre-X Minerals Ltd.*, [1998] 41 O.R. (3d) 780 (Can.).

103. *Smith v. Chadwick*, (1884) 9 App. Cas. 187 (H.L.) (U.K.); *Gould v. Vaggelas*, (1985) 157 C.L.R. 215 (Austl.); *Carom v. Bre-X Minerals Ltd.*, [1998] 41 O.R. (3d) 780, para. 34 (Can.).

104. Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

105. Michael J. Legg, *Shareholder Class Actions in Australia—The Perfect Storm?* 31(3) U.N.S.W. L. J. 669 (2008).

106. *Boyd Knight v. Purdue*, [1999] 2 N.Z.L.R. 278 (C.A.), para.55.

107. *Johnston v. McGrath*, (2007) N.S.W.C.A. 231, paras. 37–38 (Austl.).

108. See *infra* note 121.

filtering device as shown in *Houghton v. Saunders*, it is unrealistic, and also because the general public does read entire offer documents.¹⁰⁹

Although there is a movement away from requiring reliance on the misrepresented material in an offer document, there are still two other filtering devices: materiality and causation. Thus, the issue turns on (1) whether the tests of materiality and causation are necessary even if reliance is removed, and (2) whether using a dual test of materiality and causation or a single test would be most effective.

It appears that even when the relevant legislation contains no filtering device the courts have, as a matter of practicality, implied a materiality threshold¹¹⁰ or a causation and reliance threshold.¹¹¹ In the United States, however, even though there is no requirement of causation or reliance, the threshold of materiality appears strong enough to act as the sole filtering device.¹¹²

Applying a single materiality threshold does have its advantages. It simplifies the relevant legislation, provides sufficient flexibility for the courts to reach better outcomes, and removes impediments to recovery.¹¹³ Other difficulties can be addressed by using specific remedies and by making adjustments to whether personal liability or only corporate liability is imposed. As a matter of perception it seems unjust to hold the defendant liable, essentially on a strict liability basis, if the misstatement has not caused the claimant's loss. It seems that the United Kingdom's approach of a weak requirement for causation with no requirement for reliance is likely a very effective test.¹¹⁴

Despite the foregoing, there are benefits to having a materiality threshold, which could serve as the primary test. Because the threshold requirement of materiality is already present under common law and in any event may be implied by the courts,¹¹⁵ for clarity it should be explicitly referred to in legislation. For the same reason and for consistency, the legislative threshold should also apply across the board, as opposed to only omissions or only criminal liability.

Additionally, some have suggested that a definition of materiality should be introduced into legislation.¹¹⁶ However, because materiality is

109. Corporations Act, §728 (2001) (Austl.); Financial Services and Markets Act, § 90 (2000) (U.K.).

110. *See, e.g.*, *Cackett v. Keswick*, [1902] 2 Ch. 456 (U.K.).

111. *See, e.g.*, *Smith v. Chadwick*, (1884) 9 App. Cas. 187 (H.L.) (U.K.).

112. United States Securities Act, §§ 11 & 12 (1933).

113. *Golding*, *supra* note 56, at 148, 152.

114. Financial Services and Markets Act, § 90 (2000) (U.K.).

115. *See, e.g.*, *Cackett v. Keswick*, [1902] 2 Ch. 456 (U.K.).

116. *Fitzsimons*, *supra* note 3, at 164.

generally a question of fact,¹¹⁷ this issue seems to be one that the courts are apt at addressing and the courts should therefore have the discretion and flexibility to determine this on a case-by-case basis. As materiality is an important factor in the United States test, the United States cases may be a useful reference in applying the test. There is general agreement about how materiality is determined—something is material if it could, individually or collectively, reasonably be expected to influence the decisions of investors.¹¹⁸ Additionally, reference could be made to generally accepted accounting practices, which also contain a test of materiality.¹¹⁹

(2) Liability for purchases on the secondary market

The next issue is whether liability for misstatements should be imposed when the purchase was made on the secondary market, or in other words, not purchased directly from the issuer, and, if so, whether reliance is required for liability to attach. This subsection will analyze the scope of liability by first looking at the more narrow legislation in New Zealand and comparing that to the broader legislation in the United Kingdom, as well as the recommendations of appointed Securities groups in Australia regarding secondary market purchases. Then this subsection will address the possible benefits and effects of extending the scope of redressability to include secondary market purchasers and of including the use of reliance or a presumption of reliance in that determination.

In the United Kingdom, the use of the term “acquired” makes it clear that even persons who purchase securities on the secondary market are eligible for relief if the other requirements of section 90 of the U.K. Act are met.¹²⁰ This is in contrast with the traditional common law view that only persons subscribing under a prospectus have recourse for misstatements in the prospectus. For example, in *Peek v. Gurney* the House of Lords held that the object of a prospectus was to provide investors with the necessary information to make informed decisions about whether to accept the offer to invest under the prospectus, not to make market purchases.¹²¹ This was the same approach statutorily

117. 1 HAZEN, *supra* note 100, at 377.

118. 2 HAZEN, *supra* note 100, at 506–26.

119. John Blakemore & Brian Pain, *Materiality in Accounting*, ACCA, May 1, 1998, http://www.accaglobal.com/archive/sa_oldarticles/37159; *see, e.g.*, INTERNATIONAL ACCOUNTING STANDARDS BOARD, IAS 36: IMPAIRMENT OF ASSETS.

120. Financial Services and Markets Act, § 90(a) (2000) (U.K.).

121. (1873) 6 L.R. 377 (H.L.) (U.K.); *see also* Scott v. Dixon, (1859) 29 LJ Ex 620 (Q.B.) (U.K.).

adopted under the Directors Liability Act 1890, which only attached liability when persons subscribed for or purchased securities on the faith of a prospectus. This purpose was taken to mean that no statutory remedy was available for purchases on the secondary market.¹²²

In contrast, in New Zealand legislation reflects the traditional common law and statutory approach, attaching liability only when persons have “subscribed” for securities on the faith of the prospectus.¹²³ The use of the term “subscribe” prima facie indicates that only persons that have in fact subscribed for securities directly from the issuer under the offer document are eligible for relief.¹²⁴ This is the case even if the secondary market purchaser purchased the relevant securities from the original subscriber immediately after the initial public offering. Similarly, a secondary market purchaser who relied on a particular misstatement in the offer documents before purchasing is denied relief. Black’s Law Dictionary perhaps best illustrates the distinction between an acquisition and a subscription: the definition of “acquire” is “to gain possession or control of; to get or obtain,” and the definition of “subscription” is “a written contract to purchase *newly issued* shares of stock or bonds.”¹²⁵

The N.Z. Act defines “subscribe” to include “purchase and contribute to, whether by way of cash or otherwise.”¹²⁶ The use of the word “purchase” within the definition introduces some uncertainty as to whether purchases on the secondary market are eligible for relief. However, it is settled that subscription can occur when an application form is returned by an investor together with the relevant subscription money.¹²⁷ This restricts the application of the N.Z. Act to the primary market.

Furthermore, that the N.Z. Act is designed to regulate the primary securities market is corroborated by section 6 of the N.Z. Act, which provides that the civil liability provisions do not apply to “a security that has previously been allotted.”¹²⁸ “Allot” is defined to include sell, issue, assign and convey.¹²⁹ Despite the foregoing, there is, however, some

122. *Possfund Custodian Trustee Ltd v. Diamond*, (1996) 2 All E.R. 774, 781–82.

123. New Zealand Securities Act, § 55G (1978).

124. *Id.* § 2.

125. BLACK’S LAW DICTIONARY (Bryan A. Garner, ed., Thomson West 8th ed. 2004) (emphasis added).

126. New Zealand Securities Act, § 2 (1978).

127. *DFC Financial Services Ltd. v. Abel*, [1991] 2 N.Z.L.R. 619, 626; *see also* BROOKERS SECURITIES LAW SE55G.01 (Supp. 2009).

128. New Zealand Securities Act, § 6(2), (5) (1978).

129. *Id.* § 2.

scope for the N.Z. Act to apply to the secondary market. Section 6(2) of the N.Z. Act provides that the relevant provisions apply to a previously allotted security if it was originally allotted with a view to its being offered for sale to the public in New Zealand and has not previously been offered for sale to the public in New Zealand. A security is deemed to be allotted, with respect to being offered for sale to the public, when the security is offered to the public within six months of the allotment and has not been fully paid for at the time the offer was made.¹³⁰ Although this provision appears to leave open the possibility of the securities regulations applying to the secondary market, in practical terms the gap is extremely narrow. The provision is limited to situations where the securities have not previously been offered for sale to the public. Thus, it will not catch situations where the securities have been offered to the public, purchased by a member of the public, and then sold to a third party, even if the sale occurs immediately after the original subscription. The N.Z. Act is therefore still largely limited to purchases made on the primary market.

In Australia, however, the legislative provisions reflect a different approach. The Australian provisions do not make reference to either an acquisition or a subscription, focusing instead on causation and reliance.¹³¹ This is a somewhat uncertain approach, as it cannot be said determinatively whether claimants who purchase securities on the secondary market are eligible for relief. At its edges this approach becomes the same approach as that adopted by the United Kingdom, in which there is a weak causation requirement. Although it is clear under the United Kingdom provisions that a claimant who purchased securities on the secondary market may be eligible for relief, the claim will not survive if the misstatement is so removed from the loss that causation is too tenuous.¹³²

In the mid 1980s, the Australian National Companies & Securities Commissioner established the Securities Information Review Committee (SIRC) to provide advice on the then-current law. SIRC released a report in 1987.¹³³ One of the key recommendations made by the SIRC report was that subscribers should be presumed to have invested on the faith of the prospectus or, in other words, to have relied on the prospectus. With

130. *Id.* § 6(5).

131. Corporations Act, § 729 (2001) (Austl.).

132. HUDSON, *supra* note 16, at 577–79; *see also* Financial Services and Markets Act, § 90 (2000) (U.K.).

133. SECURITIES INFORMATION REVIEW COMMITTEE, INTERIM REPORT “REFORMING THE LAW RELATING TO SECURITIES” (Nat’l Co.s & Sec.s Comm’n, July 1998).

respect to secondary market purchases, the Committee suggested that a fair balance could exist by limiting the right to compensation to purchases made within six months of the issue of the prospectus, requiring the claimant to establish that they invested by relying on the prospectus and excluding the defendant from liability if it can establish that it was unreasonable for the claimant to rely on the prospectus.¹³⁴ Thus, this effectively imposes a presumption of reliance if the purchase was made within six months of the issue of the prospectus.¹³⁵ The SIRC recommendation did not eventuate when the Aust. Act was enacted. However, it seems that this recommendation is a sound one.

The tenuous reliance requirement in secondary or distanced purchases is also illustrated in case law. As found in *Houghton v. Saunders*, the issue of whether the Post-IPO Shareholders had subscribed for securities was not raised. Nonetheless, the Post-IPO Shareholders were excluded from relief by the operation of the reliance test. The IPO Shareholders alleged that they had a claim under section 56 of the N.Z. Act as they had relied on the registered prospectus. It was said that this argument clearly could not apply to the Post-IPO Shareholders (although practically speaking it is possible that a Post-IPO Shareholder could have also read and relied on the registered prospectus prior to making a purchase on the secondary market).¹³⁶ Therefore, alternative pleadings were raised by the claimants that the untrue statements affected the share price reflected by the books or that the untrue statements had the effect of disguising the availability of a statutory remedy under the N.Z. Act; however, these were held to be inapplicable to the Post-IPO Shareholders.¹³⁷

Enlarging the group of possible claimants to persons who simply acquire securities—not just persons who subscribe—and removing the test of reliance would mean that secondary market purchasers would be able to bring a claim. This may be desirable as a misstatement might cause secondary market purchasers loss or damage even though they may not have viewed or read the offer document. For example, in *Houghton v. Saunders*, the Post-IPO Shareholders suffered loss from the drastic decrease in the share price brought about by the inaccurate net profit forecast in the prospectus. Furthermore, it is also possible that Post-IPO Shareholders may in fact have read and relied on offer documents.

Such an approach is essentially the United Kingdom's approach,

134. *Id.* para. 6.3.

135. *Id.* para. 6.3.3.

136. *Houghton v. Saunders*, [2009] N.Z.C.C.L.R. 13, para. 115 (H.C.).

137. *Id.* para.119.

which requires only that the misstatement affect the price of the security.¹³⁸ However, despite the benefits of such an approach, the result seems to be an extremely broad test which adds pressure on the test of causation and does not adequately limit liability to genuine cases. Furthermore, because any number of market factors may affect the price of a security, it is extremely difficult to attribute a difference in the price of a security to a particular misstatement, making the test nearly impossible to apply.

As mentioned above, with respect to secondary market purchasers, the SIRC recommendation to have a rebuttable presumption is a sound one. Imposing a straight test of reliance seems too narrow, while doing away with reliance seems too broad. Thus, the midpoint would be a rebuttable presumption of reliance. It is reasonable to expect that secondary market purchasers who acquire their securities within a short time period after the initial offer of securities would have had reference to the offer documents. They can therefore be presumed to have relied on the offer documents. As they are only secondary market purchasers, this should only be a presumption. The issuer may then prove otherwise.

In summary, the various ways countries deal with secondary market purchasers is useful in determining a more effective method. The New Zealand approach of attaching liability only where the claimant has subscribed for securities is extremely narrow. This is especially so in the modern era, where trading on the secondary market is much more widespread than initial subscriptions for securities. On the other hand, the United Kingdom's approach of allowing relief to all claimants who have acquired securities adds unnecessary pressure on the test of causation and may cast the net too wide. Thus, secondary market purchasers should be given the ability to bring a claim for loss or damage caused by misstatements, but only if they have relied on the offer documents and can prove it. For purchasers who acquire their securities within a short time period of the registration of the offer documents (e.g., six months), this test can take the form of a rebuttable presumption of reliance.

III. WHO IS CIVILLY LIABLE FOR MISSTATEMENTS IN OFFER DOCUMENTS?

There is some variance among the jurisdictions in the key classes of persons held liable for misstatements in offer documents. The two

138. Financial Services and Markets Act, § 90 (2000) (U.K.).

classes of persons that will be discussed in this paper are issuers and directors. With respect to the former, liability is generally strict and inescapable. However, where the issuer is a corporate entity, holding the entity liable in practice means penalizing shareholders. Therefore, the issue is whether such corporate entities should be held liable. With respect to directors, it is accepted that directors should be held liable, but the issue is whether this has any deterrent effect given the increasing significance of director and officer indemnity insurance (D&O insurance).

A. Should Issuers Be Held Liable?

One issue that stands out from the comparison of the jurisdictions is whether issuers should be held liable for misstatements. The common initial response to this is that they should be liable since the issuer is the party offering the securities and receiving money for the securities. Additionally, as the party responsible for the offer documents in the first place, the issuer should bear the liability for any misstatements therein.

However, where the issuer is a corporation and the only securities concerned are shares, seeking recourse from the issuer may not always be the fairest or most beneficial solution. The issuer is only a creation of statute, and holding a corporate issuer liable usually affects the shareholders the most, who are not themselves responsible for the misstatement. The situation differs if both debt securities and equity securities are involved, as there may then be a transfer in value from debt holders to shareholders or vice versa.

Where only shares are involved, holding a corporate issuer liable for misstatements has a number of consequences. First, if found liable, the issuer may be required to pay a monetary penalty (because corporate issuers cannot be imprisoned) and/or compensation to the affected claimants. If at the time the penalty and/or compensation payment is made the claimant still holds shares in the issuer and the issuer is solvent, the claimant is essentially paying to be recompensed. If the claimant no longer holds shares in the issuer, then the current shareholders will effectively be bearing the cost of compensating the earlier shareholders. If the issuer is no longer solvent, then the issuer will not have the ability to pay compensation and the shareholders will instead have to seek recourse elsewhere, for example from directors or insurers.¹³⁹

Second, the threat of litigation and the potential for a misstatement in

139. Helen Anderson, *Directors' Liability for Corporate Faults and Defaults—An International Comparison*, 18 PAC. RIM. L. & POL'Y 1 (2009).

the offer documents are both likely to cause the price of the issuer's shares to drop further. This exacerbates the situation described above. The cost of the litigation will also be paid for by the issuer, which again essentially means that this cost is borne by shareholders.

Third, from a non-monetary perspective, the potential misstatement will affect the issuer's reputation in the marketplace. This may have repercussions for the issuer's dealings with third parties and may affect the issuer's ability to issue new shares should the need to raise further capital arise. The issuer's reliability with respect to continuous disclosure requirements may also be questioned. While on its face this is an inevitable consequence of a misstatement or potential misstatement, the shareholders still must bear the cost.

With respect to the first issue, New Zealand's provisions provide the best solution. The issuer is liable only if the issuer is an individual. If the issuer is a corporation, then other persons, including the directors of the issuer,¹⁴⁰ are held liable for the misstatement.¹⁴¹ As issuers nowadays are rarely individuals, this effectively means that individual issuers are not typically held responsible for misstatements. This can be compared to the United Kingdom's position, which holds the issuer liable regardless of whether the issuer is an individual or a corporation.¹⁴²

With respect to the second and third issues, a decline in the issuer's share price as well as the negative effect on the issuer's reputation in the market place will occur whenever there is an alleged misstatement, regardless of whether the issuer is held liable. These consequences also arise in every situation where a corporation is held responsible for wrongdoing, for example, in violations of health and safety or environmental regulations.¹⁴³ However, in the context of misstatements, taking the first step of not holding issuers liable to pay penalties or compensation would go some way towards decreasing circularity and striking a balance in issuer liability.¹⁴⁴

Where the offeror is not the issuer, the United Kingdom's provision also holds the offeror of the securities liable for the misstatement.¹⁴⁵ This is roughly equivalent to the Australian provision, which does not refer to

140. See *infra* note 152 and accompanying text.

141. New Zealand Securities Act, §56(1) (1978).

142. UK Prospectus Rules, para. 5.5.3(2) (Financial Services Authority Handbook 2010).

143. See, e.g., Robert M. Feinberg & David K. Round, *Share-Price Responses to Antitrust Enforcement in Australia: Do Investors Care About Price-Fixing Cases?*, 13 COMPETITION & CONSUMER L.J. 1, 22–23 (2005).

144. New Zealand Securities Act, § 56(1) (1978).

145. U.K. Prospectus Rules, para. 5.5.3(2) (Financial Services Authority Handbook 2010).

the issuer, but simply holds the person making the offer liable.¹⁴⁶ This is also true of the New Zealand position, which defines “issuer” to include the offeror of the security.¹⁴⁷ The offeror is not the issuer where the securities are purchased on the secondary market. However, because of the limited application of the N.Z. Act to primary market transactions, the inclusion of offerors in the definition of “issuer” does not help to extend its application to the secondary market.¹⁴⁸

The terms “offeror” and “person making the offer” are not defined in any of the jurisdictions. Needless to say, the terms are broader than the term “issuer,” and as drafted would seem to encompass any vendor, even if the vendor had no part to play in the initial issue of the securities or the preparation of the prospectus.¹⁴⁹ This approach does not seem entirely rational, as it is difficult to draw a line of causation between an unrelated third party individual who sells his or her securities on a listed exchange and a loss suffered by the purchaser from a misstatement in the offer document.

However, the United Kingdom places a limitation on the liability of an offeror that is not the issuer. The United Kingdom’s regulations limit the liability of an offeror that is not the issuer where the prospectus was drawn up primarily by the issuer and the offeror makes the offer in association with the issuer.¹⁵⁰ However, this limitation is hardly sufficient, as the offeror is only protected if it makes the offer in association with the issuer, which will not be the case where the offeror is an unrelated third party individual.¹⁵¹

The United Kingdom and Australian provisions would benefit from increased limits on the liability of offerors. For example, an offeror should be held liable only if the offeror was involved in the preparation of the offer document. The same recommendation would be made if New Zealand were to expand its legislation to deal more broadly with purchases on the secondary market. Ensuring that civil liability is adequately restricted will prevent high quality issuers from leaving the capital markets and provide incentives for issuers generally to comply with the securities regulations. It will also ensure that adverse selection does not occur.

146. Corporations Act, § 729(1) (2001) (Austl.).

147. New Zealand Securities Act, § 6(7).

148. DFC Fin. Serv’s Ltd v. Abel, [1991] 2 N.Z.L.R. 619; *see also* BROOKERS SECURITIES LAW SE55G.01 (Supp. 2009).

149. HUDSON, *supra* note 16, at 542.

150. U.K. Prospectus Rules, para. 5.5.7R (Financial Services Authority Handbook 2010).

151. *Id.*

B. The Effect of Holding Directors Liable for Misstatements

If issuers are not liable for misstatements, then the alternative is to hold the directors of the issuer liable. The directors are, after all, the controlling mind and body of the issuer and are the individuals behind the offer of securities. This subsection will discuss the central issue that arises in the context of directors: whether holding directors liable for misstatements has any effect given the emergence of director protection devices such as exculpatory provisions and D&O insurance. This subsection also considers the balance between, in Senator Sherry's words, "promoting accountability and ensuring suitable people are willing to serve as directors and take appropriate business risks."¹⁵²

There are subtle differences between the scope of the provisions holding directors, proposed directors, and persons represented to be directors liable in each of the jurisdictions. For example, in Australia each director is liable by virtue of his position as director, whereas in New Zealand only persons who have signed a prospectus as director or on whose behalf the prospectus has been signed are liable.¹⁵³ In effect, in all three jurisdictions persons who are directors of the issuer when the offer documents are published or securities are issued are held liable.¹⁵⁴ Additionally, persons who authorise themselves or have consented to be named in the offer documents as a proposed director and have been named as such are also held liable.¹⁵⁵

In recent years, the growing prominence of directors' duties and liabilities has led to the increasing significance of indemnification rights and insurance protection for directors.¹⁵⁶ While it is generally accepted that in order to prevent corporate failure and protect the integrity of the market there needs to be adequate regulation of directors, it is now also generally accepted that in order to attract and retain skilled personnel, companies must offer protection to directors, such as exculpatory protection and D&O insurance.¹⁵⁷

152. Press Release, Senator Nick Sherry, Minister Welcomes COAG Decision on Directors' Liability, (Dec. 18, 2008), available at <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/097.htm&pageID=003&min=njs&Year=&DocType=>.

153. With respect to investment statements in New Zealand, directors are liable by virtue of their status as director. See New Zealand Securities Act, § 56(1) (1978).

154. U.K. Prospectus Rules, para. 5.5.3(2) (Financial Services Authority Handbook 2010); Corporations Act, §729(1) (2001) (Austl.); New Zealand Securities Act, §56(1).

155. U.K. Prospectus Rules, para. 5.5.3(2) (Financial Services Authority Handbook 2010); Corporations Act, §729(1) (Austl.); New Zealand Securities Act, §56(1).

156. DIRECTORS' LIABILITY AND INDEMNIFICATION: A GLOBAL GUIDE 5 (Edward Smerdon ed., Globe Law and Business 2007).

157. Emiliios Kyrou, *Deeds of Indemnity, Access and Insurance—The Lurking Corporate*

Before agreeing to be directors, potential directors now typically request that exculpatory and indemnification provisions be provided by the company.¹⁵⁸ However, there may be prohibitions on the provision of indemnities by a company in certain circumstances. For example, under the Aust. Act a company may not indemnify against liability incurred by a director when it is liability of the company or liability to a third party that arose out of bad faith.¹⁵⁹ Indemnity may not be provided for legal costs in defending proceedings in which the director is found to have a liability or in defending criminal proceedings in which the director is found guilty.¹⁶⁰

In the United Kingdom, although indemnification may be provided by a company, D&O insurance is still vital in certain circumstances. Indemnification often includes claims brought by persons who purchase shares in the company based on alleged misstatements.¹⁶¹ However, in line with the Australian position, no indemnity may be given for defending criminal proceedings in which the director is convicted or civil proceedings brought by the company where judgment is given against the director.¹⁶² Thus, in these circumstances, D&O insurance becomes crucial.

However, although D&O insurance is widely available in many countries, including the United Kingdom and Australia, and likely increasingly so in New Zealand, there are also some profound limitations. There are a number of standard exclusions from D&O insurance policies, including exclusions for liability stemming from misstatements in offer documents.¹⁶³ While separate insurance coverage could be purchased with respect to such liability, it is extremely expensive and may not be justified. In addition, there are increasing gaps between the scope of indemnities provided by companies, the extent of D&O insurance coverage, and the liabilities for which directors expect to be indemnified.¹⁶⁴

Given the current status, it appears that holding directors liable for misstatements in offer documents does correctly focus directors on the importance of ensuring that offer documents are entirely accurate and not

Governance Dangers, 15 BOND L. REV. 47 (2003).

158. *Id.* at 49.

159. Corporations Act, § 199A(2) (2001) (Austl.).

160. *Id.* § 199A(3).

161. DIRECTORS' LIABILITY AND INDEMNIFICATION, *supra* note 155, at 330.

162. Companies Act, § 234 (2006) (U.K.).

163. Michael Quinlan & Mark Lindfield, *Directors' and Officers' Insurance*, COM. L.Q., March–May 2008, at 25.

164. *Id.* at 26.

misleading. Directors cannot take their responsibilities lightly with respect to offer documents when they may not be indemnified or fully covered by D&O insurance. Even if they have some level of protection, the uncertainty involved in bringing a claim under a deed of indemnity or the insurance policy still provides some incentive for directors to take their duties seriously.

To the extent that a company provides a device to protect directors from liability, there is an element of circularity involved in holding directors liable for misstatements. This is similar to the circularity involved in holding the issuer liable¹⁶⁵ in that the company (and therefore indirectly the shareholders) pays for the insurance or is required to indemnify directors under the indemnity. In the context of directors, however, this is simply the cost of attracting and retaining skilled directors. Furthermore, the level of protection provided by a company to directors is dependent on individual negotiations.

In the last few years there has been increasing debate, especially in the Australian context, as to whether securities regulation is imposing too much of a burden on directors.¹⁶⁶ This has been said to result in suitable persons being reluctant to be directors. Securities regulation was originally used to promote and encourage the stability of the financial market, but excessive regulation makes directors overly risk-averse, to the detriment of economic growth.¹⁶⁷ Over-regulation “limits the scope for innovation, undermines entrepreneurial drive and reduce[s] productivity and competition.”¹⁶⁸ Over-regulation also leads to adverse selection, as high-quality issuers have means of raising funds outside of the capital market (for example by wholesale issue), leaving only low-quality issuers left in the capital market.

Regulation needs to be appropriately targeted to balance accountability and entrepreneurialism.¹⁶⁹ This balance needs to exist wherever directors’ duties and liabilities are concerned. Specifically, in the context of misstatements in offer documents, holding directors liable is crucial to deterring undesirable conduct and providing some form of

165. See *supra* note 153 and accompanying text.

166. See, e.g., Robert Baxt, *A New Deal for Directors? At Last Some Movement on the Personal Liability Front*, 37 AUSTL. BUS. L. REV. 63 (2009); see also Nancy Milne, *Is Regulation Going Too Far? The Financial Services Regime and its Burden on Directors and Management*, COM. L.Q. June–Aug. 2007, at 33.

167. Anderson, *supra* note 139, at 2.

168. Media Release, Regulation Task Force, Taskforce on Reducing the Regulatory Burden on Business, (Oct. 2005), <http://www.regulationtaskforce.gov.au/media/mediarelease>.

169. Michael Adams, *Australian Overregulation?—Effect on Directors’ Liability*, KEEPING GOOD CO.S, Mar. 2009, at 95.

redress for persons affected by the misstatement. Since the inclusion of directors in the list of “responsible persons” is non-negotiable, the valve can be regulated by having appropriate defences.¹⁷⁰

IV. ENFORCEMENT OF MISSTATEMENTS: DO THE REGIMES WORK?

It is difficult to know, looking only at the relevant legislative provisions, whether these provisions are working effectively to strike the right balance in providing an adequate level of investor protection. One way to answer this question is to analyse the cases that have (or have not) been brought before the courts. However, cases bringing action for misstatements in offer documents are unfortunately lacking, especially in the United Kingdom and New Zealand. Australia has had more activity in this field, but this seems to be attributed to the structural accessibility of the courts, such as the ability to bring class actions and the use of litigation funding, rather than to the breadth of the provisions imposing liability for misstatements.¹⁷¹

Because the effectiveness of the regimes hinges so much on their structure, this section considers whether the structure of the regimes in the three jurisdictions enables misstatements to be adequately policed.

The enforcement of accurate offer documents is best seen as a broad concept that encompasses not just claims addressed in court for misstatements in published offer documents, but also *ex ante* enforcement undertaken by regulators and advisers prior to publication. A number of methods of enforcement are considered below, followed by a discussion of how to strike the right balance in the level of enforcement.

A. Ex Ante Enforcement by Public Authorities

In the United Kingdom, Australia, and New Zealand, offer documents must be lodged with the relevant authorities before the commencement of the offering, which include the Financial Services Authority (UKFSA), the Australian Securities and Investment Commission (ASIC) and the Registrar of Companies (NZRC), respectively. Already at this early stage there is a divergence in the level

170. While the issue of defenses is not discussed in this article, in broad terms the available defenses in each jurisdiction seem to align with the ease with which liability is imposed for misstatements. For example, the test for liability in New Zealand has a high threshold, and the available defenses are correspondingly narrow. In the United Kingdom and Australia it is easier for liability to attach, but also easier to establish a defense.

171. Legg, *supra* note 105, at 669.

of oversight and enforcement activity undertaken by each of the authorities.

In the United Kingdom, section 87A of the U.K. Act places the responsibility of approving a prospectus in the hands of the UKFSA. The UKFSA is not able to approve a prospectus unless it is satisfied that, among other things, the prospectus contains the necessary information and is compliant with all the other requirements.¹⁷² In Australia, offer documents lodged with the ASIC are not pre-vetted by the ASIC, although compliance reviews are carried out selectively.¹⁷³

In New Zealand, the NZRC's role is primarily that of record keeper and policer of formal issues. This role is separate from that of the NZSC, which is the body that may cancel or suspend the registration of a prospectus (including when the prospectus contains a misstatement).¹⁷⁴ The NZRC may refuse the registration of a prospectus if it contains a misstatement, but the NZRC does not generally investigate the truth of particular statements.¹⁷⁵ In practice, the NZRC conducts a pre-registration review of prospectuses to determine if they are suitable for registration approval.¹⁷⁶

In none of the countries does registration or lodgement of offer documents guarantee that the documents comply with the relevant securities regulation provisions. However, the relevant authorities carry out varying degrees of oversight and vetting. Anecdotal evidence suggests that United Kingdom and New Zealand authorities appear to be more stringent than Australian authorities.¹⁷⁷

B. Ex Post Facto Enforcement by Public Authorities

In terms of ex post facto enforcement, where an alleged misstatement is brought to the attention of the regulatory bodies, the regulatory bodies can generally stop the offering from proceeding if defects are discovered in offer documents. For example, the ASIC may extend the period for which applications cannot be accepted by the issuer (this is known as the "exposure period") as well as issue interim or final stop orders.¹⁷⁸ The NZSC can suspend or cancel offer documents, remove them from the

172. Financial Services and Markets Act, § 87A(1)(b) and (c) (2000) (U.K.).

173. BAXT, BLACK, & HANRAHAN, *supra* note 29, at 181.

174. New Zealand Securities Act, § 44 (1978).

175. New Zealand Securities Commission, *The Bulletin No. 1*, Mar. 1, 1984, at 3.

176. Cathy Quinn & Wendy Cook, *Registration of Prospectuses*, in CHARLES MORISON, MORISON'S COMPANY AND SECURITIES LAW (LexisNexis, Wellington, 2004 reissue).

177. Eilís Ferran, *International Company and Capital Markets Law*, Lecture at Univ. of Auckland (July 2009) [hereinafter Ferran, *International Company*].

178. BAXT, BLACK, & HANRAHAN, *supra* note 29, at 182.

market, and publicize these actions.¹⁷⁹

Where an offering has proceeded without the intervention of the regulatory bodies and a misstatement is subsequently alleged, the regulatory bodies may conduct a review of the offer documents. Typically a report is then issued on whether a breach of the relevant statutory provisions has occurred. Because this review and reporting process may be time consuming, a substantial period of time may elapse from when the misstatement is first alleged to when a case is brought.

If the regulatory bodies determine that the offer documents do contain a misstatement, the UKFSA, ASIC, and NZSC may bring a civil case or refer the case to criminal proceedings. However, as discussed above, few cases on misstatements have been brought before the courts. The UKFSA in particular has historically been known to be light-handed in its approach,¹⁸⁰ although in recent times this appears to be changing.¹⁸¹ In Australia, the ASIC is reluctant to bring civil proceedings where potential private plaintiffs have sufficient funds to do so themselves.¹⁸²

Under the N.Z. Act, the NZSC is specifically and exclusively empowered to make an application to the Court for a pecuniary penalty order or a declaration of civil liability.¹⁸³ Section 55D of the N.Z. Act provides that the purpose of the declaration of civil liability is to allow a claimant (which may be the NZSC or a subscriber) to rely on the declaration in proceedings for compensation. The declaration of civil liability is conclusive regarding the liability of the person and the conduct constituting the event, and the claimant is therefore not required to prove the civil liability event.¹⁸⁴

This feature of New Zealand's securities regulation is rather unique. It provides a link between public and private enforcement that is not available in the other jurisdictions. This increases the accessibility of the courts to private individuals, as the cost and effort involved in bringing a

179. New Zealand Securities Commission, *What We Do*, <http://www.sec-com.govt.nz/about/what-we-do.shtml#1> (last visited Sept. 30, 2009).

180. John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 241, 310 (2007).

181. Jamie Symington, Head of Wholesale Department, UKFSA, Address at City and Financial Market Abuse Conference: The UKFSA and Enforcing the Market Abuse Regime (Nov. 6, 2008), available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/1106_js.shtml.

182. Peta Spender, *Securities Class Actions: A View from the Land of the Great White Shareholder*, 31 COMMON L. WORLD REV. 123, 155 (2002). See also Austl. Sec. & Inv. Comm'n [ASIC], *Intervention*, PS 4, RG 4.4.

183. New Zealand Securities Act, § 55C (1978).

184. *Id.* § 55D.

claim may otherwise be prohibitive. With a declaration of civil liability, private individuals may rely on the enforcement actions taken by the public authorities and, in effect, piggyback on those enforcement actions. However, this only works if the public enforcement authority adequately polices and enforces misstatements, which in New Zealand's case is highly debatable.¹⁸⁵

C. Private Enforcement and Shareholder Class Actions

The alternative to public enforcement of wrongdoing is private enforcement. However, it is unusual for an individual claimant to bring a case, as the costs and time involved are likely to be prohibitive. Furthermore:

The isolated individual inevitably lacks sufficient motivation, information and power to initiate and pursue litigation against the powerful producer. Even if such an unlikely event should occur, the result would be wholly inadequate to discourage the mass-wrongdoer from continuing the profitable damaging activities; the individual plaintiff would be the "owner" of an insignificant *fragment* of the damage involved.¹⁸⁶

If the case is strong and the amount of the claim is substantial, it may be worthwhile for an institutional investor to bring the case.¹⁸⁷ Then, if the institutional investor is successful, this can provide opportunities for other individual investors to also bring separate claims.

As individual claims are unlikely and unviable, the shareholder class action has emerged as another mechanism of private enforcement of good corporate governance.¹⁸⁸ Shareholder class action involves one shareholder bringing a claim on behalf of other shareholders who have the same claim against the same defendant.¹⁸⁹ Shareholder class actions offer economies of scale which are not otherwise available.

185. Recent occurrences in the New Zealand market, including that of Feltex and Blue Chip, where the persons responsible for huge losses by the New Zealand public have escaped unscathed, seriously erode the reputation of the NZSC and the integrity of the New Zealand capital market.

186. Mauro Cappelletti, *Alternative Dispute Resolution Processes within the Framework of the World-Wide Access-to-Justice Movement*, 56 MOD. L. REV. 282, 284 (1993).

187. Michael Legg, *Institutional Investors and Shareholder Class Actions: The Law and Economics of Participation*, 81 AUSTL. L.J. 478 (2007).

188. Ben Slade & Julia Tang, *Shareholder Class Actions—A Mechanism to Encourage Corporate Responsibility*, 70 PRECEDENT 4 (2005).

189. *Id.*

Shareholder class actions have long been prevalent in the United States, but are now a fast-growing phenomenon in Australia.¹⁹⁰ The reduction of costs, the introduction of financing, and the increased prospects of success are also said to be converging and leading to greater litigation of shareholder claims.¹⁹¹

Investor actions and class actions have not gained similar momentum in the United Kingdom or New Zealand.¹⁹² One significant reason for this is the lack of an opt-out procedure in these jurisdictions. In an opt-out procedure, the class of persons bringing the claim is described inclusively. This means that persons who come within the description are included as part of the class and will be bound by the judgment unless they take steps not to be.¹⁹³ In contrast, an opt-in procedure requires each person who wishes to be part of the proceedings to take affirmative steps to be included in the class.¹⁹⁴

In the United Kingdom, investor actions may be brought under the group litigation order regime, which operates on an opt-in basis. However, no cases involving misstatements in offer documents have been brought using the regime.¹⁹⁵ In New Zealand, attempts have recently been made to bring proceedings using an opt-out procedure, but these attempts have proven unsuccessful thus far.¹⁹⁶

In *Houghton v. Saunders*, representative orders were given by Associate Judge Faire and allowing the proceedings to be on an opt-out basis. This meant that both the IPO Shareholders and the Post-IPO Shareholders would automatically be part of the proceedings unless they gave notice to be excluded. These orders were challenged by the defendants in the High Court.

On the appropriateness of the opt-out procedure, Justice French found that the “notion [that] someone can become a party to a court proceeding without their consent is somewhat alien to our way of thinking.”¹⁹⁷ While an opt-out procedure was relatively common in other jurisdictions including Australia, the New Zealand High Court Rules do not contain any provisions allowing an opt-out procedure. In the absence

190. Legg, *supra* note 105, at 669.

191. *Id.* at 670.

192. Ferran, *US-Style Investor*, *supra* note 3, at 317.

193. Spender, *supra* note 182, at 138.

194. *Id.* at 137.

195. Rachael Mulheron, *Reform of Collective Redress in England Wales: A Perspective of Need* (2008), available at http://www.civiljusticecouncil.gov.uk/files/collective_redress.pdf.

196. See *Houghton v. Saunders*, [2009] N.Z.C.C.L.R. 13 (H.C.).

197. *Id.* para. 157. While this view was certainly more prevalent in the past, it now appears to be somewhat outdated for modern times.

of legislative change, Justice French found that the opt-out procedure had to be replaced with an opt-in procedure.¹⁹⁸

The opt-out procedure is seen as “the hallmark of the class action.”¹⁹⁹ In the United States, the opt-out procedure was introduced in 1966, leading to an increase in class action activity.²⁰⁰ In Australia, class actions by an opt-out procedure have been available in the Federal Court since 1992 and in Victoria since 2000, although they are not available in other states.²⁰¹

The opt-out procedure helps provide protection to consumers and to the market by reducing the cost of court proceedings and enhancing access to legal remedies for individuals. Unwilling and vulnerable individuals are grouped into the class by default, increasing the opt-out procedure’s access to justice and promoting the efficient use of court resources.²⁰² The opt-out procedure also ensures consistency amongst cases with common issues and increases the enforceability and effectiveness of the law.²⁰³

Opponents of the opt-out procedure criticize the class action for including in the class individuals who do not wish to litigate and those who are indifferent. However, various means have been adopted to allow individuals who oppose bringing suit to be excluded from the class, such as repetitive opt-out rights at different stages of the litigation and detailed notice requirements explaining the opt-out rights.²⁰⁴ Indeed, it is crucial that the opt-out procedure captures the indifferent and those who might otherwise be dissuaded from bringing suit by various social, psychological, or economic barriers, as this will prevent under-compensation.²⁰⁵

The opt-out procedure should be seriously considered in the United Kingdom and New Zealand. Justice French in *Houghton v. Saunders* sums it up well:

Having regard to developments in other jurisdictions, it is highly likely claims of the type brought in this

198. *Id.* para. 168.

199. Spender, *supra* note 182, at 137.

200. J. FRIEDENTHAL, M. KANE & A. MILLER, *CIVIL PROCEDURE* 722 (2d. ed., 1993).

201. Slade & Tang, *supra* note 188, at 4.

202. Rachael Mulheron, *Justice Enhanced: Framing an Opt-Out Class Action for England*, 70 *MOD. L. REV.* 550 (2007).

203. Vince Morabito, *Class Actions: The Right to Opt Out Under Part IVA of the Federal Court of Australia Act 1976 (Cth)*, 19 *MELB. U. L. REV.* 615 (1994).

204. Mulheron, *supra* note 202, at 556.

205. *Id.*

proceeding will become increasingly common in New Zealand. No doubt it is that consideration which has prompted the Rules Committee to seek to introduce new class action Rules. Such claims pose new challenges for the Courts, and the Court must be ready to accommodate them as best it can.²⁰⁶

D. Private Enforcement and Litigation Funding

Another aspect that affects the amount of private enforcement is how the litigation is funded. Historically, the funding of litigation by third parties gave rise to the torts of maintenance and champerty.²⁰⁷ Maintenance involves a person (called a maintainer) providing others with funding to enable them to undertake litigation. If the maintainer is able to interfere or direct the course of the litigation and is entitled to share in the proceeds if the outcome is successful, then champerty exists.²⁰⁸

For reasons of public policy, mainly the prevention of abuse of court process for personal gain, many viewed maintenance and champerty negatively. However, there exists the public policy of facilitating access to justice, which makes it desirable for third parties to provide financial assistance to enable claimants to have the benefit of legal representation.²⁰⁹

Litigation funding involves a contract between a funding entity and the claimants. Under the agreement the funder pays the costs of the litigation if the case fails.²¹⁰ In common law jurisdictions where the losing party is liable for the winning party's costs,²¹¹ the funder also agrees to pay the other party's costs if the case fails. If the case succeeds, then the funder receives a percentage of the proceeds and is usually reimbursed for costs.

The legality of litigation funding was considered for the first time in Australia in *Campbells Cash and Carry Pty. Ltd. v. Fostif Pty. Ltd.*²¹² The High Court found that litigation funding was not an abuse of process

206. Houghton v. Saunders, [2009] N.Z.C.C.L.R. 13, para. 227 (H.C.).

207. Graeme Gurney & Michael Legg, *Shareholder Activism: Consumerism, Class Actions and Litigation Funding*, 25 AMPLA Yearbook 255 (2006).

208. R v. Everything Else Inc. v. Hallenstein Bros Ltd., (2001) Hamilton CP17/98, para. 35 (H.C.) (N.Z.).

209. Gulf Azov. Shipping Co. Ltd. v. Idisi, [2004] E.W.C.A. Civ. 292, para. 54 (U.K.).

210. Legg, *supra* note 187, at 478.

211. RACHAEL MULHERON, *THE CLASS ACTION IN COMMON LAW SYSTEMS: A COMPARATIVE PERSPECTIVE* 443–44 (Hart Publ'g, Oxford 2004).

212. (2006) 229 C.L.R. 386 (Austl.).

or contrary to public policy. The joint judgment of Judges Gummow, Hayne, and Brennan did not impose a blanket bar on litigation funding and stated that fears of funders conducting themselves in a way that was detrimental to the administration of justice could be addressed by existing doctrines of abuse of process.²¹³

Campbells Cash and Carry was cited in *Houghton v. Saunders*, where the defendants accepted that a merely champertous arrangement would be insufficient and that something more than maintenance and profit sharing would be required before the arrangement could constitute an abuse of process.²¹⁴ In determining whether abuse of process existed, the court considered various factors, including whether the funder stood to gain an excessive or disproportionate profit, whether the funder had no genuine commercial interest in the cause of action, and whether the funder was only seeking to resolve the dispute to make a profit.²¹⁵ Given the scale and complexity of the claim, the court found that the litigation funding arrangement did not amount to an abuse of process warranting a stay.²¹⁶

Litigation funding promotes access to justice, improves efficiency, and spreads the risk of complex litigation.²¹⁷ The availability of litigation funding promotes shareholder class actions by providing necessary resources, like time and money, that individuals may not otherwise have. Funders also have incentives to monitor disclosures in offer documents and elsewhere to identify possible causes of action.²¹⁸ This enhances investor protection and encourages issuers to provide accurate and sufficient disclosure.

E. Striking the Right Balance

The rise of shareholder class actions and litigation funding has contributed to increased policing of issuers by what has been termed the “private attorney-general.”²¹⁹ On one hand this may be beneficial by keeping issuers in check. On the other hand, there are strong concerns that jurisdictions should not move towards a litigation culture that pervades securities regulation, such as in the United States.²²⁰ Already in

213. *Id.* para. 93.

214. *Houghton v. Saunders*, [2009] N.Z.C.C.L.R. 13, para.179 (H.C.).

215. *Id.* para. 180.

216. *Id.* para. 190.

217. Legg, *supra* note 105, at 704.

218. *Id.*

219. Spender, *supra* note 182, at 124.

220. INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKET REGULATION (2006); COMMISSION ON THE REGULATION OF US CAPITAL MARKETS IN THE 21ST CENTURY, REPORT AND

Australia the convergence of class actions, reduced costs, improved prospects of success in litigation, and a shift towards a consumerism mindset that is quick to blame may be causing the perfect storm.²²¹

Given the stronger emphasis on public enforcement in the United Kingdom and New Zealand, this phenomenon has yet to arrive in these jurisdictions.²²² New Zealand's legislation provides a good balance between public and private enforcement by allowing private enforcement to piggyback on public enforcement and preventing an overlap between the two. However, private enforcement under this arrangement is highly dependent on the effectiveness of the public enforcement authority, which at present is highly questionable in New Zealand and is only in its infancy in the United Kingdom.²²³

As capital markets and securities regulation continue to develop, demographics will play an important role in the level of enforcement demanded by the public. As the baby boomers near retirement age and start investing larger sums of money in the capital market, it is likely that mismanagement and misstatements will become less tolerable. Some will call for tougher sanctions and increased enforcement. Securities regulation will inevitably have to keep up with these trends, including providing for class actions and allowing the use of an opt-out procedure.

V. CONCLUSION

It is not easy to strike the right balance in securities regulation. This is the case not only in designing the rules that hold persons liable for misstatements in prospectuses, but also in the rules that enable potential claimants to bring causes of action against liable persons. Both over-enforcement and under-enforcement can have a damaging effect on the capital market. In each case a balance needs to exist between investor protection and the freedom of issuers and management to make decisions. Factors such as discouraging excessive litigation and maintaining the integrity of the market are also important considerations for these issues.

Each of the three jurisdictions has different means of striking the right balance. For example, New Zealand has a narrow test for the imposition of liability for misstatements, but this is balanced by a broad class of persons being held liable for misstatements and narrow defences

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221. Legg, *supra* note 105, at 705.

222. Ferran, *US-Style Investor*, *supra* note 3, at 345–46.

223. Ferran, *International Companies*, *supra* note 177.

available to those persons. In the United Kingdom and Australia, it is much easier for liability to attach, but this is balanced by the fact that it is also easier to establish a defence.

In terms of enforcement, it is possible to go too far but it is also possible to not go far enough, as arguably was the case in the United Kingdom a number of years ago. While suggestions can be made as to how the law could improve, each approach requires analysis in the context of the overarching policies and market conditions in each jurisdiction.

It is not necessary or even desirable to have both a stringent civil liability regime and a strong enforcement regime. Having both, as the United States does, can lead to excessive litigation. However, having both is better than having a relaxed civil liability threshold combined with a weak enforcement regime, as New Zealand arguably does. Perhaps it is most important to keep a close watch on the issue, for without deliberate and methodical action it is unlikely that the right balance will exist.

