The restructured prospectus offering provisions of the Corporations Law have now been in place for more than two years, a period in which the financial markets have favoured capital raising and a number of major initial public offerings have been completed. However, concerns remain about the appropriateness of the due diligence processes that have developed in Australia to address liability concerns. Greg Golding and Stephen Minns assess current issues relevant to the due diligence debate and suggest areas in which improvements might be made.

The new laws which govern the preparation of prospectuses — and particularly those touching on liability implications of the due diligence process — are not entirely satisfactory. Fine-tuning is required, as is demonstrated by the (as yet unimplemented) recommendations of the Lonergan Committee in 1992. Concern is commonly expressed over the following issues:

Cost: Prospectus preparation is clearly a much more expensive process than before 1991. Float costs (including underwriting) are typically between 3 per cent and 5 per cent of total funds raised for major floats, with proportionately higher costs for smaller capital raisings. In our view these costs are in fact consistent with US and UK experience, but the perception is that the Australian practice is not providing value for money.

Delay: There has been significant volatility in worldwide capital markets in the past two years. At the same time, the prospectus preparation process has blown out to three or four months. A lengthy preparation process imposes unacceptable risk on the issuer and/or underwriter.

Focus: Inquiries lack focus. Tales abound of professionals missing the wood for the trees in their due diligence inquiries. For most issuers it is not difficult to identify the key risks and disclosure issues that will arise with prospectus preparation. On the other hand, a large amount of cost and time is spent on peripheral issues with no proper risk assessment.

Over the past two years a fairly uniform checklist/committee approach to due diligence has developed. The current practice can be summarised as follows.

- A due diligence committee is formed comprising directors, members of management, underwriter representatives and professionals.
- The committee supervises inquiries, makes materiality decisions, reviews the prospectus and reports to the board of the issuer on its activities.
- A checklist of the inquiries to be made is developed. The checklist is extremely detailed and typically similar to, or based on, the SIA guide.
- Inquiries are conducted on behalf of the committee and reports are prepared by information gatherers.
- Legal sign-offs are typically provided by the issuer’s lawyer, management sign-offs are provided by re-
sponsible management and accounting sign-offs (in addition to the investigating accountants' report) are typically provided by the accountants.

- The prospectus is verified line by line during its preparation.

It is our view that significant improvements can be made to the above process. Some of the measures described below have already been successfully used in recent floats.

**Jettison the checklist!**

In our experience the chief difficulty with the current procedures is the detailed, apparently comprehensive, checklist that is settled as the first step of investigation. The checklist lacks focus, tending to give equal importance to all issues and therefore failing to identify and give priority to risk areas.

Because it lacks focus the resulting inquiries can be time-consuming and superfluous to the real issues. The committee members may waste time sifting through largely irrelevant reports, become bored and neglect the detail of critical issues.

In our view, a redirection of inquiries at the outset of the transaction would identify the key issues, allow committee members to properly understand risk factors and enable an early assessment of the key issues to guide the prospectus preparation process. We recommend the following staged process.

**1. Scoping review**

The initial scoping review should be designed around the following:

- interviews with divisional management to discuss historical performance, past problem areas, budgeting experience, internal reporting systems, strengths, weaknesses, opportunities, threats and forecasts;
- interviews with auditors to discuss accounting principles, audit history and audit issues;
- review of materials generated by internal reporting systems (board reports, management reports, board minutes, management minutes);
- review of organisational structure, management authorities and board procedures.

The scoping review should be clearly delineated and strictly timetabled. As a consequence of the scoping review, an issues memorandum should be approved and presented to the board of the issuer, containing an agreed list of preliminary issues for analysis.

Each member of the committee should have access to the issuer's internal reporting systems and receive copies of all information provided to senior management. Where any deficiencies are identified in internal reporting systems (it being recognised corporate governance is a developing area in Australia), they should be remedied.

Reliance on professional and expert advice enhances the defences of each person with potential liability under the Corporations Law. Subject to cost, the referral of key issues to experts is therefore desirable. Relevant issues could include profit and cashflow forecasts, tax, environmental and actuarial aspects. The experts should be retained on the basis of past float experience and should submit detailed work programs for committee review.

**2. Detailed inquiry functions**

Based on the work conducted in accordance with the issues memorandum, the detailed work should focus on:

- **Prospectus preparation** — the initial draft of the prospectus can be prepared on the basis of the scoping review.
- **Expert reporting** — the committee will be provided with reports based on the work programs that were settled with the experts and other professional advisers.
- **Issues analysis** — as issues arise (either from the scoping review or subsequent work) they should be assessed and resolved through “issues reports”. Questionnaires will be particularly helpful in this area. Responses from divisional management as well as middle management should be considered.
- **Internal reporting systems** — the committee members should receive copies of all information generated by the internal reporting system. Management reports should be modified to cover the disclosure criteria for the prospectus and report on the issues memorandum, so as to draw attention to any matter bearing on those issues.

**3. Sign-offs**

The sign-off process will have the following elements (which are generally consistent with current practice):

- prospectus verification;
- expert and other professional adviser sign-offs;
- management sign-offs;
- committee report to the board of directors.

This process will require modification to deal with the unique aspects of each offering (for example, a rights offering will typically allow a much more streamlined scoping review and require less expert involvement). The framework for inquiries and the staged due diligence process should be agreed in advance and recorded in a due diligence procedures memorandum.

**The reasonableness dilemma**

The concept of “reasonableness” of inquiry establishes the threshold of the various due diligence defences in the legislation. Historically, the ambiguity of this concept has resulted in people involved in prospectus preparation adopting a “lowest common denominator” approach to inquiries, often with insufficient attention to risk assessment. We offer the following observations on ways to address the problems that arise in this area.

**Function**: While there is no meaningful Australian law on the due diligence defences, it seems inevitable that variable standards will be imposed on participants in the prospectus preparation process. Individuals should tailor their part in the process accordingly.

Directors and underwriters can rely to a significant degree on experts for “expertised” parts of the process.

They can delegate and rely on work conducted by others provided they have approved a credible system and have supervised that system and have no reason to believe that there are unresolved issues.

The directors must apply their particular skills to the inquiry task (eg, if the director is a lawyer or accountant) and the adequacy of inquiries must be assessed by reference to the particular knowledge of the individual (eg, if the director is an executive or is on the due diligence committee).

Underwriters should adopt an “adversarial” approach to inquiries, particularly in dealing with management, and should verify matters presented by management on key issues. It is important to appreciate that what may be reasonable for directors, particularly in relation to reliance on
management, may not be reasonable for the underwriter.

Experts and professionals must apply the skills of their profession to the parts of the prospectus for which they are responsible.11

Role: A number of issues affect the potential liability and defences of a professional adviser. Matters which should be settled at the outset include:
- The decision to be named or not named in the prospectus.12
- The taking of indemnities or contribution arrangements from the issuer.13
- Defining and limiting liability through being named for part only of a prospectus.14

The materiality dilemma

The concept of “materiality” establishes the threshold of potential liability for misstatements (including omissions). The ambiguity of this concept has also confused or disturbed individuals involved in prospectus preparation. An appreciation of materiality should be settled among the participants at the outset.

We favour the United States test of materiality; that is, whether there is a substantial likelihood that a reasonable shareholder would consider the matter important in exercising an investment decision.15 The test is inherently ambiguous but, on the positive side, it imposes a reasonably high threshold and it is likely that experienced participants will know there is a problem when they see it.

We consider quantitative or percentage-based criteria simplistic. There is a role for these criteria but they should not be taken as determinative. We note that accounting standard AAS 516 is to similar effect.

Some other lessons

Most people involved in major floats over the past two years have lists of horror stories. Much can be learned from those floats. Some of the lessons we would point to (in no particular order) are:
- Settle sign-offs of the due diligence reports at the outset.
- Settle the underwriting agreement at the outset.
- Take care in choosing an appropriate chairman for the due diligence committee as a counterbalance to the problems of decision-making by committee.

Do not let the due diligence committee become involved in irrelevant issues such as marketing or underwriting.
- Place greater focus on timetabling.
- In the interests of reduced cost, consider deferring the float until the time of preparation of annual accounts.

A great deal of time and effort has been devoted in Australia to the development of due diligence programs to address the new prospectus liability provisions of the Corporations Law. The fundamental difficulty with the entire regime remains the overlapping liability provisions of section 52 of the Trade Practices Act and the state Fair Trading Acts. These provisions give rise to potential liability for innocent misstatements with no due diligence defence available.13

The only advantage of a due diligence program is to minimise the prospect of a misstatement occurring in the first place. In our view, the overlapping liability regime is fundamentally flawed and is not an appropriate model of securities regulation.18 There is a pressing need for law reform in this area.

Underwriters should adopt an “adversarial” approach to inquiries, particularly in dealing with management.

Notes
1. More detailed description can be obtained from, among other sources, McGrath, "Underwriters Can't Be Overcareful", JASSA, December, 1992, p. 7; Browne, O'Bryam and Kearney, 1992, "Prospectus Due Diligence under the Corporations Law" (BLEC Annual Due Diligence Workshop).
4. See also Defining for "expected" provisions of the prospectus in section 1008A(2) for directors and the defence of reasonable reliance on others in section 1011(1)(b) for the issuer, underwriters, promoters and persons who authorize or cause the issue of the prospectus.
5. See text accompanying note 6.
6. See for example Stevens v Hare (1991) 20 TLR 407 and compare with Shepard v Bromage (1994) AC 342; Adams v Thrift (1915) 1 Ch 557, 2 Ch 221. As to systems and supervision, see the trade practices case law of Universal Telecasters (Qld) v Goodricke (1973) 18 ALR 331. The Australian position is likely to be further contrasted with the US position which is also based on the same English case law referred to above — Ernst v BarChris Construction Co, 283 F Supp 643 (1968).
7. A helpful description of the US approach (on which this analysis is based) is contained in the leading article Folk, "Civil Liabilities Under the Federal Securities Acts: The BarChris Case" (1969) 55 Va L Rev 1 ("Folk"), particularly at 21-42. It is interesting to contrast that analysis with cases such as Adams v Thrift — the similarity is striking.
8. In the absence of English/Australian law on this point we have reached this conclusion by contrasting the US Ernst v BarChris Construction Co, analysis — see particularly at p. 267. For analysis see Folk at pp. 36, 79-82. In our view the policy issues underlying the imposition of this standard in the US are likely to be similar in the Australian context. It is generally assumed, for example, that Canada will follow the US approach — see Thornop, "Part 14 of the New Securities Act: due diligence comes to BC", (1988) 22 Uni of British Columbia L Rev 279.
9. See the standard of section 1009(2) and section 1009(3).
10. This issue revolves around the consequences of deemed liability under section 1006(2) to a director from potential accessorial liability under section 79. Section 1006(2) gives rise to consideration of the Corporations Law defences. Section 79 gives rise to knowledge issues without the availability of defences — see Folk v Lucas (1985) 158 CLR 661; Crandon Marketing Ltd v Griffith Vintners Pty Ltd (1989) 91 ALR 271.
11. Care is required in this area as it cannot be assumed that such indemnities will always be enforceable — see Broom Jenkins & Co Ltd v Percy Dawes (London) Ltd (1957) 2 QB 621; Alcoy v Golden Wine Co Ltd (1948) 2 KB 35. Also compare with the US position — Gilbert v Lawn Research Service Inc 418 F 2d 1276 (1969).
12. See section 1010 of the Corporations Law.
13. See TSC Industries Inc v Northway Inc Inc 426 US 438 (1976); Basic v Levinson (1987) CCH 93,310. Compare this standard with the similar (but less refined) approach in the UK/Australian context of cases such as Cocker v Kronel (1902) 2 Ch 456.
15. No fraud, recklessness or negligence in the making of the statement is required. That position is clear — see for example Parkdale Cotton Built Furniture Pty Ltd v Pacen Pty Ltd (1982) 149 CLR 191 at 197; Vole v Lucas (1985) 159 CLR 661 at 675.

FOOTNOTES

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