4. Offer To The Public

This section considers the concept of "offer to the public" in section three of the Securities Act 1978. The concept derives from United Kingdom law and first appeared in New Zealand company legislation in 1901. Australia, Hong Kong, Malaysia and Singapore also adopted the concept from UK law. Australia, Hong Kong and Malaysia have long abandoned the concept and Singapore did so in 2005. In this writer's view, New Zealand should abolish the concept and adopt the Australian practice as contained in Chapter 6 D of the Corporations Act 2001 (Cth.).

4.1 Meaning of "Offer"

Once an instrument has been characterised as a security (see the preceding section), the second major requirement for a transaction or scheme to come within Part II of the Act is that there be an "offer" of that security. Section 2 defines the term "offer" as follows:

> "Offer" includes an invitation, and any proposal or invitation to make an offer; and to offer has a corresponding meaning.

The meaning of this provision has been considered in a number of cases and is best considered in conjunction with section 3(1)(c) which provides:

> A reference to offering the securities to a person if the person became known to the offeror as a result of any advertisement made by or on behalf of the offerer and that was intended or likely to result in the public seeking further information or advice about any investment opportunity or services.

Section 3(1) (c) will be considered later. As to the term "offer", Anderson J in *Orr v Martin* stated:

> … for the purposes of the Securities Act 1978 the term "offer" has a far broader meaning than such term has in, for example, contractual law. It encompasses concepts, which in the law of contract amount to invitations to treat, and such extended meaning is entirely consistent with the consumer protection nature of the Act itself.[1]

The courts do not require formal solicitation in order to find an "offer". In *Re Dingwall & Paulger Ltd (in rec); Re Steel v NZ Guardian Trust Co.*, the company had, since the 1930's:

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1 *Orr v Martin* (1991) 5 NZCLC 67,383, 67,390.

> ... [T]aken cash deposits from its shareholders and employees and treated them much as a banker would. The funds earned interest and were repayable on demand. People came to learn of the scheme by word of mouth from family and friends or fellow employees. The existence of the scheme was never advertised or publicly notified. By 1984 there were some 350 depositors to a total value of perhaps $350,000.[2]

Here, Ellis J was faced with the issue of whether or not there had been an offer to the public. His Honour referred to the definition of "offer" in section 2 and commented: "[I] am satisfied that the stock was offered by creating it and letting it be known that it was available".[3] Ellis J did not accept that the company had been passive in soliciting offers since it had received funds over a period of time. Accordingly, active solicitation was not necessary - the mere making of the securities available by word of mouth was sufficient. The *Culverden* decision supports such wide interpretation of offer and, overall, the courts have had no difficulty interpreting the term in the manner parliament intended. By contrast, the term "public" is inherently nebulous. Here, the problem is not the aberrant exercise judicial discretion; indeed, one sympathises with the courts attempts to make sense of the statutory definition. The problem is the concept itself.

4.2 Offer of Securities to the Public

4.2.1 Introduction

The third requirement needed to bring a transaction within Part II of the Act is that the security has been offered *to the public*. This section argues that retention of the public offering test is a case of evolutionary maladaptation in the 78 Act. To place this proposition in context, consider Mark Roe's application of recent evolutionary theory to legal change.[4] Roe's view of the implications of that theory for legal change was that nothing important might happen except in a crisis. What survives the crisis is that which is best adapted to persist during the crisis. After the crisis, the maladapted become extinct and nothing much happens until the next crisis. Roe's view, therefore, is that which survives the crisis is filled with efficiencies and inefficiencies; on the whole the species was good enough to survive but "any one of its features may be maladapted". The retention of the public offering test in the Securities Act 1978 after the Securitibank crisis is a striking example of evolutionary maladaptation. Why? First, because the

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2 (1990) 5 NZCLC 66,780, 66,782.
3 Id, 66,790.
4 M. Roe, "Chaos and Evolution in Law and Economics" (1996) 109 Harvard LR 641.

problems associated with the concept were well known prior to the 1978 Act. Second, because the case law on section 3 of the 1978 Act shows that those problems remain; the section is an inefficient, uncertain and costly mechanism for ascertaining when the disclosure provisions of the Act must be deployed.

Section 3 of the Act attempts to define the term "public". The definition is also important for the application of Part 4 of the SMA since section 41 of that Act imports section 3 of the 78 Act apart from section 3 (2) (a) (iia) – investment by person of $500, 000).

Section 3(1) provides:

> (1) Any reference in this Act to an offer of securities to the public shall be construed as including-
>
> (a) A reference to offering the securities to any section of the public, however selected; and
>
> (b) A reference to offering the securities to individual members of the public selected at random; and
>
> (c) A reference to offering the securities to a person if the person became known to the offerer as a result of any advertisement made by or on behalf of the offerer and that was intended or likely to result in the public seeking further information or advice about any investment opportunity or services, -
>
> whether or not any such offer is calculated to result in the securities becoming available for subscription by persons other than those receiving the offer.

while section 3(2) provides:

> (2) None of the following offers shall constitute an offer of securities to the public:
>
> (a) An offer of securities made to any or all of the following persons only:
>
> (i) Relatives or close business associates of the issuer or of a director of the issuer:
>
> (ii) Persons whose principal business is the investment of money or who, in the course of and for the purposes of their business, habitually invest money:
>
> (iia) Persons who are each required to pay a minimum subscription price of at least $500,000 for the securities before the allotment of those securities:
>
> (iii) Any other person who in all the circumstances can properly be regarded as having been selected otherwise than as a member of the public:

Section 3(1) is the *inclusive* part of the definition and paragraphs (a) to (c) are aimed at negating decisions prior to the passing of the Act that had the effect of narrowing the meaning of term "the public". Section 3(2) is the *exclusive* part of the definition and defines those offers that fall outside the provisions of Part II. In addition to the exclusions in section 3(2)(a), an invitation to enter into a bona fide underwriting agreement is outside the terms of the Act: see section 3(2)(b) of the Act. As to the section 3(2) exclusions, note the overlap with the exemptions contained in section 5 (2CB) of the Act for wealthy or experienced persons.

Section 3(3) makes it clear that a pre-existing relationship with the offeree is not sufficient to avoid the application of Part II. Under this subsection, the fact that an offer is made to a person who is a purchaser of goods from, or is an employee or client of, or the holder of securities in, the issuer does not of itself prevent such an offer from being an offer to the public. Under section 3(5) proof of an offer to *one member of the public* selected as a member of the public is prima facie evidence of an offer of securities to the public.

Section 33 of the Securities Act 1978 provides that securities may only be offered to the public by way of an investment statement, authorised advertisement or registered prospectus. The provision is central to the investor protection rationale of the legislation; enabling investors to make informed decisions about the financial state of the issuing entity and comparisons with other offerings. The term "public" implies that disclosure is not necessary every time a company offers securities and is complemented by statutory provisions exempting "non-public" offerings. In most cases, however, the threshold question for an issuing entity is whether its securities will be offered to "the public".

4.2.2 History: Early Definition and Case law

The concept of "offer to the public" was first introduced to New Zealand by the Companies Act 1901,[5] which also provides the first statutory definition of a prospectus.[6] The definition extended the normal contractual meaning of an offer by catching invitations and imported the troublesome concept of "offer to the public" to New Zealand from the U.K. The 1901 Act

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5 1 Edw VII, No 58.

6 Section 2 defined prospectus as, "any prospectus, notice, circular, advertisement, or other invitation offering to the public for subscription or purchase any shares or debentures of a company".

definition of a prospectus reappeared in section 2 of the Companies Act 1955. The prospectus provisions of the 1955 Act applied only where the invitation or offer to subscribe for or purchase securities of a company was made to "the public".[7] Section 63 of the 1955 Act was designed to assist in determining whether an offer was to "the public" for the purposes of that Act. Section 63(1) provided that any reference in the Act to offering shares or debentures to the public should be construed as including a reference to offers:

> to any section of the public, whether selected as members or debenture holders of the company concerned or as clients of the person issuing the prospectus or in any other manner...

This definition was extremely wide but was restricted by section 63(2) which provided:

> This section shall not be taken as requiring any offer or invitation to be treated as made to the public if it can properly be regarded, in all the circumstances, as not being calculated to result, directly or indirectly, in the shares or debentures becoming available for subscription or purchase by persons other than those receiving the offer or invitation, or otherwise as being a domestic concern of the person making and receiving it.

Although present in New Zealand statutes since 1901, the meaning of "offer to the public" was never fully defined in any of the early statutes. The first attempt to define fully the concept of "offer to the public" occurred in section 3 of the Securities Act 1978.

The early absence of statutory definition caused problems with the meaning of the word "public". A significant body of case law developed as courts attempted to define the concept. As with the case law under the 1978 Act, this merely served to increase uncertainty surrounding the term. The proposition is illustrated by the early cases. Thus, it was held that an offer to one person might be sufficient to be an offer to "the public".[8] In another case, it was held that the greater the number of offerees, the more likelihood that the offering is a public offering. Marking the prospectus "for private circulation only", did not prevent an offer from being "public".[9] An offer to a small and select circle of friends, customers or other persons related to

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7 See the definition of "prospectus" in s 2 of the Act.

8 *Nash v Lynde* [1929] AC 158, 169 (HL) per Viscount Sumner. " 'The public' ... is of course a general word. No particular number is prescribed. Anything from two to infinity may serve; perhaps even one, if he is intended to be the first of a series of subscribers, but makes further proceedings needless by himself subscribing the whole."

9 *Re South of Natural Gas and Petroleum Co* [1911] 1 Ch 573. The Court held that there was a public offer where a promoter sent prospectuses marked "for private circulation only" to more than 3,000 shareholders in certain companies.

the issuer, was likely to be regarded as a "domestic concern" and hence not an offer to the public.[10] Hence, a prospectus marked "strictly private and confidential; not for publication," distributed by the directors of a company to their friends was not a public offer.[11]

If the offer was calculated to lead to the securities becoming available for subscription or purchase by persons other than those receiving the initial offer - albeit only a few - then it was an offer to the public.[12] If the offer could be accepted only by a specified class of offerees, it was not treated as an offer to the public in some circumstances.[13] By contrast, another case held that where an offer was capable of acceptance only by a limited number of persons it could not be public notwithstanding that if the offer was rejected by the original offerees, the same offer would be extended to other persons until an acceptor could be found.[14] In *Corporate Affairs Commission v David Jones Finance Ltd.*[15] an invitation to more than 12,800 employees of subsidiaries of the issuer was not a public offer because, notwithstanding that the number of offerees was great, it was not capable of acceptance by anybody other than the defined class of offerees.[16] Elsewhere in Australia, it was held that an invitation to the public means one made to the public generally and capable, therefore, of being acted upon by any member of the public.[17]

Case law had not resolved the meaning of the term "the public" prior to 1978.[18] Indeed, it was plain that the term had limited utility on account of the uncertainty surrounding it. The need for legislative change was obvious and the impetus for such change was provided by the collapse of

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10 See s 63(2) Companies Act 1955 (NZ).

11 *Sherwell v Combined Incandescent Mantles Syndicate Ltd* (1907) 23 TLR 482 (CD). See also the dissenting judgment of Windeyer J in *Lee v Evans* (1964) 112 CLR 276 (HC).

12 See s 63(2). See also, *Burrows v Matabele Gold Reefs and Estates Co Ltd* [1901] 2 Ch 23, 27 (overruled on other grounds by *Hilder v Dexter* [1902] AC 474 (HL)).

13 In *Government Stock and Other Securities Investment Co. Ltd. v Christopher* [1956] 1 WLR 237, 242 (CD) Wynn-Parry J stated "... the test is not who receives the [offer] but who can accept the offer put forward." In that case, a circular sent by a company to all the shareholders in two other companies, offering to acquire all their shares in exchange for shares in the offeror company, was held not to be a prospectus since, inter alia, the offer made by the circular could be accepted only by the shareholders in the two offeree companies.

14 *Lee v Evans* (1964) 112 CLR 276, 287 (HC).

15 (1975) 1 ACLR 239 (SC).

16 But see the discussion of the case in Baxt, Ford and Samuel, *An Introduction to the Securities Industry Acts* (1st ed., 1977) where the authors argue that had the company offered shares or debentures, and not simply invited the offerees to deposit money with it, the equivalent provision under the Uniform Companies Act to s 63(1) - which refers only to offers of shares or debentures and not to invitations for deposits or loans - would have applied. The provision precludes an argument that an offer or invitation to a section of the public to subscribe for shares or debentures is not an offer to the public.

17 *Hamilton v Austcan Property Investment Pty Ltd* (1981) 5 ACLR 469; (1981) 55 ALJ 883 (SC).

18 G. Weiss, "The Concept of 'Public Offering' under the Securities Act 1978" (1982) 12 VUWLR 105, 109.

Securitibank.[19] In the result, the Working Party convened to examine the collapse recommended a full review of the whole body of law relating to the raising of funds from the public.[20] Nonetheless, despite compelling evidence to the contrary in the case law, the 1978 Act retained the concept of "offer to the public". The retention of this concept in the 1978 legislation represents an evolutionary maladaption to the crisis caused by the Securitibank collapse. The attempt to clarify an offer to "the public" in section 3 of the Act has been unsuccessful. In the result, rather than providing greater certainty as parliament intended,[21] the provisions of section 3 extended the uncertainty contained in the prior legislation. This can be illustrated by the early case law on section 3 of the 1978 Act.

4.2.3 Early Case Law on Section Three of the Securities Act 1978

In *Robert Jones Investments Ltd v Gardner and Anor*,[22] the plaintiff company, RJI, had offered shares to existing shareholders, institutions and other high net worth individuals. Gardner was an existing shareholder who purchased shares on a deferred payment arrangement but failed to complete the purchase after the sharemarket crash of 1987. RJI sued Gardner on the purchase contract. Tipping J. heard the summary judgment application by RJI and attempted to reconcile the inherent conflict between two sub-paragraphs of section 3. Section 3(1)(a) provides that any section of the public *however selected* will fall within the Act while section 3(2)(a)(iii) exempts persons *selected otherwise* than as a member of the public.[23] The process of selection appears to

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19 See G. Walker, "Reinterpreting New Zealand Securities Regulation" in G. Walker, Gen. Ed., *Securities Regulation in Australia and New Zealand*, 2nd ed (1998), 88.

20 Working Party, 78.

21 *NZPD* Vol 421, 1978, 3935. In the Second Reading of the Securities Advertising Bill, the Minister for Justice, Hon D. Thomson MP said: "Clause 3, which defines what constitutes the public for the purposes of the Bill has undergone substantial rewriting to give more certainty, in view of the wide application of the Bill, to precisely what is or is not an offer to the public ... it does represent a substantial clarification of this part of the law."

22 (1988) 4 NZCLC 64,412 (HC). Hereafter, "*Gardner (No 1)*". In this case, the plaintiff company sought summary judgment for moneys owing under an allotment agreement for its shares. The defendant allottee, a shareholder in the company, alleged in defence that the issue was void under the Securities Act 1978 as the offer had not been made in a registered prospectus. The plaintiff argued that the offer fell within the exemption in s 3(2)(a)(iii) because the offerees could properly be regarded as having been selected otherwise than as members of the public. The shares were offered to existing shareholders who on investigation were, in terms of the company's selection criteria, "either professional investors or of substantial enough worth to handle the inherent risk in the allotment". Id, 64,416.

23 Emphasis added.

be irrelevant in the former sub-paragraph, yet relevant in the latter.[24] Tipping J. rejected the view of Darvell and Clarke[25] that section 3(2)(a)(iii) was limited to merely clarifying the preceding sub-paragraphs (i) and (ii). His Honour thought that the person referred to in section 3(2)(a)(iii) could be a person standing alone.

Tipping J suggested a solution to the tension between section 3(1)(a) and section 3(2)(a)(iii) by reading section 3(1)(a) as casting a wide net over any section of the public, however selected. By contrast, His Honour thought section 3(2)(a)(iii) was concerned with "an individual person or individual persons who have been selected not by reason of their being members of a section of the public, but truly as individuals."[26] Hence, the key question was whether the offer had been made to persons chosen for their distinct and personal characteristics. This solution does not remove the difficulty of distinguishing between a section of the public and a group of individuals selected truly as individuals.[27]

In the substantive hearing of *Robert Jones Investments Ltd v Gardner*,[28] Hansen J. observed that section 3(1)(a) is extremely wide on its face and found it hard to imagine any offer that was not prima facie an offer to the public.[29] Hansen J thought that although under section 3(3) an existing shareholder is *prima facie* regarded as a member of the public (and even if selected as "an existing shareholder", will not by that reason alone be regarded as selected otherwise than as a member of the public),[30] any consideration of section 3 must be viewed against the overall

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24 J H Farrar and M W Russell, *Company Law and Securities Regulation in New Zealand* (1985), 354.

25 R P Darvell and R S Clarke, op cit, 69.

26 *Gardner (No 1)*, 64,418.

27 Tipping J adverts to the problem when noting that an offer to a group of shareholders, even a small group, is still an offer to the public (s 3(3)). His Honour thought that the extra criteria used by RJI in selecting potential offerees (that the offerees were either professional investors or of substantial enough worth to be able to handle the inherent risk in the allotment), may have brought the offer within the s 3(2)(a)(iii) exception: id, 64,419. Yet such selection still involves a section of the public ie, shareholders in RJI with investment experience and or high net wealth. These persons are selected according to certain common criteria which reduce their individuality and, hence, they could arguably fall within the description "any section of the public, however selected". In almost every case it would seem possible that some common elements would be found between the offerees thereby making them prima facie "a section of the public". If, as suggested by Tipping J, the criteria used by RJI brings s 3(2)(a)(iii) into play, then the difference between s 3(1)(a) and s 3(2)(a)(iii) becomes one of degree. The greater the degree of abstraction involved the more likely that the s 3(2)(a)(iii) exception comes into play. This suggests an approach that looks at the number of criteria used to select offerees. But where is the line to be drawn and in what circumstances? This approach does little to promote certainty in the law.

28 (1993) 6 NZCLC 68,514 (HC). Hereafter, "*Gardner (No 2)*".

29 Although Hansen J speculated that perhaps if an offer were limited to institutions and directors then it may fall outside the term public. Id, 68,529.

30 Id, 68,529.

statutory aim of the Act.[31] In furtherance of this purposive approach, Hansen J considered that a Court must look at all the persons to whom the offer was made. The exclusionary provisions of section 3(2)(a) will only apply if all of the persons to whom the offer was made fall within paragraphs (i) to (iii).[32] This immediately raises forensic and cost problems since it requires an examination of *all* persons to whom an offer was made. This is objectionable on grounds of commercial certainty, litigant expense and court costs.

As to the exception under section 3(2)(a)(iii) (which provides an exception where any person in *all the circumstances* can properly be regarded as having been selected otherwise than as a member of the public), Hansen J. considered that it was necessary to look at and balance all competing circumstances.[33] Taking into account the fact that RJI had approached brokers (which lent a possible public aspect to the issue),[34] and balancing this against factors such as: the small number of allotments made; the fact that no automatic right of participation in the issue existed; that those participating were substantial investors, and, that some individual contracts were agreed as between the parties, Hansen J characterised those offerees not directly before the Court as persons truly selected as individuals.[35] On these criteria, Hansen J. seems to have identified persons described elsewhere as "sophisticated investors".[36] However, the fact that Hansen J. did not include the Gardners in this category, preferring to stretch the bounds of the "habitual investor" exemption, shows uncertainty over the applicability of the "selected otherwise than as members of the public" exemption.

Ferguson v Robert Jones Investments Ltd,[37] was another summary judgment application arising from the same fact-pattern as *Gardner*. The key point to note about *Ferguson's Case* is the

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31 This is to facilitate the raising of capital by securing the timely disclosure of relevant information to prospective subscribers for security. It is aimed at the protection of investors, and is consumer oriented legislation. Id, 68,529.

32 Id, 68,530.

33 Ibid.

34 Id, 68,533.

35 Hansen J after satisfying himself that the initial allotments were to institutional investors or close business associates, concluded that the balance of the individuals were, "... all substantial shareholders in RJI. They all dealt through brokers, and had the opportunity of professional advice. They were in a position to agree to "lock up" their shares for considerable periods of time, which carried with it an inference of a substantial financial state. They were individually considered. I am satisfied they were selected truly as individuals, and not as members of the public." Id, 68,514.

36 T Dodd, "Offer to the Public in New Zealand - The Return of Gardner" (1993) 11 C&SLJ 392. Dodd states that, "His Honour's approach to the exception provisions ... is driven by the policy of the Act as investor protection legislation. Where investors are sophisticated, have substantial financial backing and are selected on this basis, it is inappropriate to require full disclosure in the form of a registered prospectus". Id, 396.

doubt that it casts upon Hansen J.'s decision in *Gardner (No 2)*.[38] In *Ferguson*, Master Thomson criticised many of the factors employed by Hansen J.[39] Thus, Master Thomson considered that the small size of the allotment need not be determinative.[40] Likewise, the fact that there was no automatic right of participation did not preclude the offer from being a public one.[41] Master Thompson considered that simply because a person is shown to be a substantial holder of shares and appears to live off investment income is not conclusive evidence that they are a share market trader and dealer.[42] Neither the fact that the shares were embargoed nor that individual contracts were negotiated with some investors necessarily resulted in a non-public offer.[43] Such a requirement could equally apply to a public offering.

Master Thompson identified one salient problem with section 3. Pursuant to section 3(5), an offer need only be made to one person for it to be prima facie an offer to the public. The logical implication is that if one offeree can be characterised as a member of the public, then the entire offer is prima facie an offer to the public.[44] Hence, all offerees must be examined to see if they fall within the exclusions in section 3(2) of the Act. Although Hansen J had adverted to the point, such an examination was not undertaken in the *Gardner (No 2)*.[45] In this way, *Ferguson* highlights an important point about section 3. The words of section 3(5) are quite clear: once an offer has been made to one member of the public, then, prima facie, there is an offer to the public. Thus, if Mrs Gardner had been examined, it is submitted that she must have been found to be a member of the public since she was neither a habitual investor nor an existing shareholder but had invested on the advice of Mr. Gardner. The forensic problem (but not the position of Mrs Gardner), was clearly identified by Master Thomson - every investor (and query every

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37 (1995) 7 NZCLC 260,668 (HC). Hereafter, "*Ferguson*".

38 G Walker, "Offer to the Public in New Zealand - *Ferguson's Case*" (1995) 13 C&SLJ 213.

39 P Fitzsimons, "Capital Raisings and Offers to the Public" (1995) 1 C&SLB 4, 7. Fitzsimons argues that, Master Thomson's criticisms overlook the fact that Hansen J considered a dozen factors together, whereas Master Thomson isolated four factors and criticised them individually.

40 Relying on *Re Loan and Finance (Dunedin) Ltd (in rec)* (1990) 5 NZCLC 66,367 (HC) where an offer accepted by 42 existing investors was held to be an offer to the public. There is also support for this proposition in s 3(5) of the Act, which states that: an offer need only be made to one person for it to be prima facie an offer to the public.

41 Id, 260,675.

42 One cannot exclude the possibility that a substantial part of his holding may have been acquired by gift or inheritance or that the bulk of the estate consists of a few large investments made over a lengthy period of time. Id, 260,674.

43 Id, 260,675.

44 Ibid.

45 Id, 260,675.

offeree),[46] must be examined by the Court. This is hardly a cost-effective solution to a policy of investor protection.[47] Further, section 3(5) offers the potential for those who do not need the protection of the Act to benefit by simply showing that there was an offer to only one person as a member of the public and thereby tainting the entire offer. In the result, the Act can be used as a shield by investors to avoid contracts unimpeachable on conventional grounds rather than a sword for investor protection against unauthorised offers.

Ferguson also illustrates the scope for exercise of judicial discretion in determining whether or not an objective, subjective or other test is to be used when considering whose belief determines whether or not an offer is public. Prima facie, the words of section 3(1) "whether or not any such offer is calculated to result in the securities becoming available for subscription by persons other than those receiving the offer", suggest that the offeror's view is irrelevant.[48] In *Ferguson*, Master Thompson thought the correct test was an objective or half way test,[49] deriving from the Australian case of *Corporate Affairs Commission (SA) v Australian Central Credit Union.*[50] Master Thompson reasoned that such an approach assisted the Act's purpose of investor protection and provided commercial certainty.[51] In order to satisfy this test there must be some subsisting or special relationship between the offeror and members of a group or some rational connection between the common characteristic of members of a group and the offer made to them.[52] But as Teresa Shreves points out:

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46 Section 3(1) applies whether or not the offer is calculated to result in the securities becoming available for subscription by persons other than those receiving the offer indicating that the focus of the section is on those persons to whom the offer is made rather than on those who accept. See *Orr v Martin* (1991) 5 NZCLC 67,383 at 67,391 (HC). Selection of investors for allotment of shares in an issue is different from their selection as the object of a relevant "offer" as the term is defined in the Securities Act 1978.

47 See further, G Walker, "Offer to the Public in New Zealand - *Ferguson's Case*" (1995) 13 C&SLJ 213, 215.

48 Id, 260,678 - 260,679.

49 The half way test uses the perspective of the offeror but asks, when an offeror is contemplating making an offer to a particular group, whether the group as seen by a reasonable person in the shoes of the offeror is a section of the public. In the Master's view, this test would enable an offeror's intention to be recognised, provide commercial certainty, and, might lead to a different result than that in *Gardner (No 2).* Id, 260,679.

50 (1985) 3 ACLC 792 (HC). Brennan J used a half way test while Mason ACJ, Wilson, Deane and Dawson JJ all preferred a completely objective test. Note that no previous New Zealand decision had relied upon or indicated that this case had any value when applying s 3. Doogue J explicitly rejected the use of both Australian and United States authorities in *Kiwi Co-operative Dairies Ltd v Securities Commission* [1994] MCLR 306, 312 (HC). Earlier, Hansen J had commented in *Robert Jones Investments Ltd v Gardner* (1993) 6 NZCLC 68,514 at 68,529 (HC) that although Australian decisions offered some assistance by way of guidance, they were of limited assistance.

51 Id, 260,679.

52 Id, 795. Examining the facts in *Gardner*, Master Thomson thought that it was arguable that all those solicited to participate in the share issue through sharebrokers were members of a special group where there was either some special relationship between the offeror and the group (in that they were already substantial

> … the case is troublesome because it introduces into New Zealand yet another test, the "rational connection" test. This test, like many of the existing tests and factors used by the Courts in New Zealand, including those found to be irrelevant in *Ferguson,* has little to do with the purpose of the legislation.[53]

In *The Society of Lloyds and Oxford Member's Agency v Hyslop,*[54] Richardson J. considered, *inter alia,* whether or not an offer of membership in Lloyds, for which there was no registered prospectus, amounted to an offer to the public. A Mr. Philip Langdale had initiated the offer in question whose brother was a partner in Hall Harford, a managing agent of Lloyds. Hence, Philip Langdale was a member's agent representing Hall Harford. The evidence was that Langdale had approached six old friends of long-standing with a view to recruiting them as Names. On this point, Richardson J commented:

> Reading s 3(1)(a) and s 3(2)(a)(iii) together I consider the proper inference is that those solicited were not selected as a section of the public. Rather they were approached as private individuals because they were old friends. Approaches to relatives and close business associates are excluded under s 3(2)(a)(i). Even if contrary to my assessment, the six old friends ... could be regarded as a section of the public, I would hold that they were selected otherwise than as members of the public.[55]

Although no explicit reference is made to the contradiction between sections 3(1)(a) and 3(2)(a)(iii), Richardson J. placed emphasis on section 3(2)(a)(iii) with regard to the manner of selection thereby implying a subjective test.[56] The fact that the offerees were old friends was regarded as distinguishing them from a section of the public. This appears to import into the sub-paragraph a new exception for "old friends".[57]

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shareholders in RJI), or there was some rational connection between the common characteristics of members of the group and the offer made to them. Those characteristics were that the offerees had to be credit-worthy and capable of purchasing a large parcel of shares. While all the purchasers examined in the judgment passed that test, it is possible that Mrs Gardner (who participated on her husband's advice) would not. Id, 260,681. In any event, such common characteristics are possessed by such a large portion of the public as to be practically meaningless as selection criterion.

53 Shreves, op cit, 117-118.

54 [1993] 3 NZLR 135 (CA).

55 Id, 142.

56 See further, A Simpson, "Offer to the Public in New Zealand - The New Old Friends Exception" [1994] NZLJ 46. This is similar to the approach taken by Tipping J in *Gardner (No 1).* The reliance placed on the intention of the offeror clearly favours a subjective approach to s 3(2)(a)(iii). Compare the mixed or objective approach in *Ferguson.*

57 Compare the earlier case of *Re Dingwall and Paulger (in rec)* (1990) 5 NZCLC 66,780, 66,790 (HC), where Ellis J stated, when considering whether or not there had been an offer to the public: "Counsel were unable to formulate the selection of depositors without including such categories as 'friends and neighbours'. This in my view cannot properly be regarded as a selection otherwise than as a member of the public." See also

There are several problems with *Hyslop*. If the case creates a new exception for "old friends",[58] then it is not clear from the judgment whether the friendship for the purposes of the exemption must exist between the investor and the issuer or whether it suffices that it exists between the investor and the issuer's representative.[59] The exemption in section 3(2)(a)(i) for relatives and close business associates, is restricted to relatives and close business associates of the *issuer*. It seems strange that an exemption for "old friends" could flow from the activities of an agent where the friendship is personal to the agent. Again, in principle, are "old friends" necessarily in a similar position to relatives and close business associates in order to glean information about an issuer? There is no reason in principle why relatives should be in a better position (although this may not hold good for close business associates). Arguably, relatives and old friends both need protection because they are less likely to scrutinise closely an issuer's proposal on account of the pre-existing relationship. Further, who are "old friends" and how does one construct a meaningful test to ascertain this class of persons? The problem is exacerbated if one adopts a subjective test because it is the issuer's, or its agents, claim that a person is an old friend that is dispositive.

In *Lawrence v Registrar of Companies* (2004) 9 NZCLC 263, 480 (CA), Canterbury Asset Management (CAM) offered securities in respect of property developments. No prospectus was in existence when the securities were offered or when they were allotted. Lawrence claimed that

section (2) (a) (iii) of the Act applied and the investors had been selected otherwise than as members of the public. The investors were alleged to have been so selected because they had been clients of a Mr. Condliffe, an employee of CAM, when he previously worked as a financial adviser. It was Mr. Condliffe who had approached the investors. The Court of Appeal said that

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International Standardbred Partnership v Garland (1992) 6 NZCLC 67,812 (HC), where the plaintiff failed to satisfy Master Williams, on a summary judgment application, that an offer to a long standing business and social acquaintance of over 20 years, during a social function was not a public offering of securities.

58 Although Hansen J alluded to such an exception in *Ferguson*, when he said: "The initial allotment was clearly to institutional investors and to close business associates, relatives or personal friends of Sir Robert Jones." Id, 68,533.

59 In this case, the friendship was not between the investor and the members' agent. Rather, it existed between the investor and the brother of the members' agent employee, although it appears that the brother may have operated under some form of authority from the members' agent, see, eg, *obiter dicta* of Richardson J "It may be that Mr Langdale had a wide authority from Oxford to assist in the recruitment of names". Id, 142. McKay J stated, "Mr Phillip Langdale said he had assisted Hall Harford in respect of the recruitment of new Names, not by active canvassing or 'cold calling', but usually by receiving approaches initiated by persons interested in becoming a Name". Id, 153.

the question of which persons fell within the sub-paragraph was an objective question of fact. Here, a previous business relationship was insufficient to exclude the offerees from the public.

4.2.4 Five Principles in Applying Section Three: The *Kiwi Dairies Case*

Some of the problems surrounding section 3 have been resolved by the leading Court of Appeal decision in *Securities Commission v Kiwi Co-operative Dairies Ltd.*[60] Here, Kiwi Dairies operated as a co-operative dairy company. Dairy farmers had to be members of the co-operative in order to sell milk. Each bought one share for that purpose. There were a total of 2,652 supplying shareholders. Kiwi Dairies solicited funds from its shareholders via a monthly newsletter and paid interest on funds deposited. No prospectus was issued. In the High Court, Doogue J. found that the shareholders were all close business associates of Kiwi and hence the offers did not constitute an offer to the public. In a unanimous judgment, the Court of Appeal reversed that finding. The Court of Appeal set out five general principles applicable to section 3 and the exceptions under section 3(2)(a).[61] While this decision has clarified a number of the problems associated with section 3, many remain.

The *first principle* flowing from the *Kiwi Dairies* decision is that the exceptions will not assist an offerer from being caught by section 3(1) unless *all the persons* to whom the offer was made come within the exceptions in section 3(2). Blanchard J, delivering the unanimous judgment of the Court of Appeal, stated:

> An issuer cannot claim the benefit of the exceptions in subs (2)(a) unless every one of the offerees is a person within subparas (i), (ii), and (iii). All need not come within the same paragraph. The opening words of para (a) refer to an offer of securities "made to any or all of the following persons only". As Mr Millard pointed out, the emphasis is on the offer and the person to whom it is made. There could be a breach if an offer were made to the public (or a single member of the public: subs (5)) and nobody accepted it.[62]

It is the offering of the security for subscription which breaches section 33, not the final allotment. Consequently, in determining whether an offer must comply with Part II of the Act, one must consider all those who *received* an offer even if some or all of them did not accept the

60 [1995] 3 NZLR 26 (CA). The fact-pattern bears a close resemblance to *Ralston Purina*.
61 Ibid, 32-33.
62 Id, 32.

offer. Here, the Court of Appeal affirmed the earlier decisions of Anderson J in *Orr v Martin*[63] and Hansen J in *Gardner (No 2)* and added a further requirement - where the question of whether the offer is public or non-public is "evenly balanced", the courts should find there is a public offer. This means that an issuer seeking to uphold an allotment pursuant to section 3 must consider examining all offerees. As claimed, such a result is objectionable on economic grounds since the process is costly, time-consuming and inefficient.

The *second principle* we can extract from *Kiwi Dairies* is that while the section does not provide any numerical limits, the larger the number of offerees the greater the possibility of section 3(2) not applying. In *Gardner (No 2)*, Hansen J took into account the limited number of persons to whom offers were made (thirty nine in total) in deciding that section 3(2)(a)(iii) did not apply. By contrast, an offer to forty-two existing shareholders was held to be a public offering in *Re Loan and Finance (Dunedin) Limited*.[64] Here, of course, section 3(5) (proof of an offer to one member of the public is prima facie proof of an offer to the public), is also relevant. Characterizing an offer as public by reference to numbers (for example, the presence of a mere three additional shareholders), produces a test that might have a place in numerology but has no place in law concerned with capital formation and investor protection.

The *third principle* is that the burden of proof is on the issuer that wishes to rely upon the exemptions in section 3(2)(a). In order for an issuer to be faced with this burden, Anderson J in *Orr v Martin* held that all that was needed was for a prima facie showing of a public offering. This places an issuer in a difficult position since Hansen J in *Gardner (No 2)* agreed with Anderson J that the wording of section 3(1)(a) was so wide that it was hard to envisage any offer that is not prima facie an offer to the public on the wording of the section. Hansen J suggested that if the offer was limited to institutions and directors, it may fall outside the term public, but, clearly, the term itself is very wide.

The Court of Appeal took up this point in *Kiwi Dairies*. Blanchard J held, taking into account the views of the Supreme Court of the United States in *SEC v Ralston Purina Co.*, that the burden of proof should lie upon the issuer wishing to plead an exemption. He saw this as being "fair and reasonable … in most cases it [would] be more a question of interpretation and judgment -

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63 (1991) 5 NZCLC 67,383.
64 (1990) 5 NZCLC 66,367.

whether the facts particular to an offeree place that person within or outside the category of close business associates of the issuer". Hence, where:

> the matter was evenly balanced … to give effect to the legislative policy of protecting offerees, the issuer will be found not to have established that the offeree under consideration fell within the category.[65]

This approach coupled with the requirement to show that each offeree comes within appropriate exemption places a substantial weight on an offerer. An error of judgment in offering to one non-exempt offeree leaves the offerer (and its officers) liable for the repayment of all the funds received under section 37(6).

The *fourth principle* goes to whether a person falling within a section 3(2) exception is to be determined on an objective or subjective basis. Blanchard J in his consideration of section 3(2) in *Kiwi Dairies* commented:

> … an existing holder of securities will have been selected as a member of the public unless the issuer can point to something else on the basis of which the offeree was actually selected, differentiating the offeree from the public generally and from that section of the public compromising the security holders. *Whether or not any existing security holder is or is not selected as a member of the public is a matter of fact to be objectively determined in each case*. Amongst the matters which may show that the selection was not made merely because the offeree held securities will, of course, be the existence of a connection of a kind referred to in subs (2)(a)(i) and (ii).[66]

As Kiwi Dairies had abandoned its reliance upon section 3(2)(a)(iii), Blanchard J had only to consider the "close business associates" exception in section 3(2)(a)(i). It is apparent, however, that Blanchard J thought the test to determine the application of all the exceptions in section 3(2)(a) was objective when he stated:

> Amongst the matters which may show that the selection was not made merely because the offeree held securities in the issuer will be the existence of a connection of a kind referred to in subs 2(a)(i) and (ii).[67]

Blanchard J used the explicit exceptions in section 3(2)(a)(i) and (ii) as examples of when the person has been selected otherwise than as a member of the public. He did not limit this point to those subparagraphs, but appeared to include section 3(2)(a)(iii) as well.

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65 [1995] 3 NZLR 26, 33.
66 Id, 30-31. Emphasis added.
67 Id, 30-31.

However, section 3(2)(a)(iii) refers to a person *being selected* "otherwise than as a member of the public". In *Hyslop,* the Court of Appeal considered this subparagraph and gave an indication as to how it considered this part of section 3(2)(a) should be approached. Richardson J, who delivered the main judgment, examined whether there had been an offer to the public in terms of section 3. Recall that Mrs Hyslop was one of six persons (including her husband) who had been approached by an old friend with the appropriate connections to the insurance industry in the United Kingdom. On this basis, Richardson J considered that they were not persons who had been selected at random in terms of section 3(1)(b), nor had they become involved through an advertisement, which removed the need to consider section 3(1)(c). His Honour then turned to section 3(1)(a) and commented:

> Reading s 3(1)(a) and s 3(2)(a)(iii) together I consider the proper inference is that those solicited were not selected as a section of the public. Rather they were approached as private individuals because they were old friends. Approaches to relatives and close business associates are excluded under s 3(2)(a)(i). Even if, contrary to my assessment, the six old friends of Mr Langdale could regarded as a section of the public, I would hold that they were selected otherwise than as members of the public.[68]

McKay J's approach to the construction of these provisions was similar in that he found that Mrs Hyslop was not a member of the public since "an offer [was] made to her as an individual, and she had not been selected at random … she was approached as being a long-standing friend of Mr Phillip Langdale". Thus, the Court of Appeal appeared to apply a subjective approach to determining whether there was an offer to the public in terms of section 3(2)(a)(iii). Richardson J emphasised the *basis* upon which the offerees were approached (as "private individuals because they were old friends") and that "they were *selected* otherwise than as members of the public". Hence, the reasons why the offerer approached these particular offerees was a critical factor in determining whether or not they were members of the public for the purposes of section 3.

The Court of Appeal's view in *Hyslop* can be supported by the wording of section 3(2)(a)(iii) which requires an examination of whether the offeree can properly be regarded as having been selected otherwise than as a member of the public in all the circumstances. These words require one to ask who is to do the selection - with the answer obviously being "the issuer". Accordingly, it appears that the intention of the issuer is relevant for the purposes of this sub-paragraph. The phrase "in all the circumstances" clearly enables the court to examine whether in

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68 *Hyslop*, supra, 142.

fact the selection was done on an individual basis and mere assertion by the issuer will not be sufficient. That mere assertion is not enough is also clear from the requirement that the offeror must show the exemptions apply. Thus, it appears that the section 3(2)(a)(iii) test is primarily subjective with the onus on the issuer to demonstrate that the selection was in fact carried out on an individual basis. The court then examines all the circumstances associated with the offer but is required to consider the offeree's viewpoint.

Prior to the Court of Appeal decision in *Lawrence* (see below) there appeared to be two conflicting views on the interpretation of section 3(2). The Court of Appeal in *Hyslop* implied that the test was subjective but in *Kiwi Dairies* the full Court of Appeal appeared to hold that the test was objective. One way of reconciling the point is to say that Blanchard J's dictum applies only to section 3(2)(a)(i) (and possibly (ii)) where the offeree is an existing security holder on the basis that Kiwi Dairies had abandoned reliance upon section 3(2)(a)(iii), and, to the extent that Blanchard's J's comments were meant to apply to section 3(2)(a)(iii) they were obiter. This would allow the two views to co-exist. Alternatively, it is possible to read down *Hyslop* on the basis that the Court was dealing with an application to dismiss proceedings on jurisdictional grounds and there was not a full hearing of the issues. However, the clear findings of the court on the section 3(2)(a)(iii) issue run against this argument.

A recent judicial pronouncement on this point is *Lawrence v Registrar of Companies* (2004) 9 NZCLC 263, 480 (CA). Here, Lawrence was charged with making offers to the public and allotting securities without a prospectus in contravention of section 59 of the 78 Act. Lawrence had offered real estate investments without a disclosure document to 106 investors who were associated with him as clients. The defence was that Lawrence had only made offers to selected individuals under section 3(2)(a)(iii) of the Act. The Court of Appeal dismissed Lawrence's appeal. The Court of Appeal held that the selection test is objective: can the persons selected objectively be seen to be in a category of persons able to protect themselves?

Accordingly, for section 3(2)(a)(i) and (ii) where the offeree is an existing security holder the test involves an objective assessment as to whether or not a person comes within those exemptions. In assessing a claim that an offer is exempt under section 3(2)(a)(iii) the initial focus is on why the "offerer" approached the offeree (that is, a subjective approach) but, overall, the test is objective.. Where the offeree is not an existing security holder (or person described in section 3(3)), the same approach should apply since there is no logical reason to distinguish between the two situations. This would appear to be the most consistent approach to the issue particularly in the light of the words "who has been selected" in section 3(2)(a)(iii).

The *fifth general principle* goes to the purpose of the Act as interpreted by the courts. In *Re AIC Merchant Finance Ltd* Richardson J stated (when considering whether or not a void issue of securities could be validated under the Illegal Contracts Act 1970 (NZ)):

> The pattern of the Securities Act and the sanctions it imposes make it plain that the broad statutory goal is to facilitate the raising of capital by securing the timely disclosure of relevant information to prospective subscribers for securities. In that way the Act is aimed at protection of investors. That aim is achieved by regulating the conduct of issuers of securities and by providing sanctions for infringement by those issuers and their officers.[69]

Richardson J further commented:

> It is perhaps true to say that the premise underlying the Securities Act, as with much commercial law, is that the best protection of the public lies in full disclosure of the company's affairs and of the security it is offering. That then allows the investor to make an informed investment decision, which in turn facilitates the functioning of financial markets.[70]

These comments were cited with approval by the Court of Appeal in *Kiwi Dairies* when the court considered the application of the exceptions in section 3(2)(a), although the court emphasised the primary importance of the words in the legislation when dealing with the exceptions.

As we have seen, the courts do not always refer to the purpose of the Act. For example, in *Hyslop,* Richardson J did not refer to legislative purpose as the starting point in his interpretation of section 3. In the same case, McKay J briefly discussed the Act's purpose in the context of rejecting an argument that the offer was made in New Zealand. Neither judge referred to the purpose of the Act in the interpretation of section 3. This is surprising in the context of *Hyslop* since persons living in New Zealand who are asked to invest in the insurance market in the United Kingdom are unlikely to have access to the type of information the Act requires to be disclosed in order to make an informed decision. Mrs Hyslop signed a document setting out the details of the syndicate she was to be involved in and attended a formal meeting but it appears that neither the documentation she signed nor the meeting she attended provided her with the

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69 *Re AIC Merchant Finance*, supra, 391.
70 Id, 392.

type of information that the Act would have required. In addition, Mrs Hyslop had no prior experience in this market and had only come upon the necessary funds through an inheritance. Given the presence of informational asymmetry, Mrs Hyslop was precisely the type of person who needed the protection afforded by the disclosure requirements of the Act. In passing, note that the decision in *Lawrence v Registrar of Companies* (see above) casts further doubt on *Hyslop*.

Analysis of *Kiwi Dairies* confirms the proposition that section 3 is a maladaptation. The first reason is that section 3(1) applies unless all the offerees come within section 3(2). In a contested matter, a litigant and the court is thus faced with examining all offerees. This is costly and time-consuming. Second, the result may well be arbitrary as the reference to the number of offerees demonstrates. Third, because the burden of proof will almost always be on the issuer and there is doubt as to whether section 3(2) requires an objective or subjective test, an issuer's adviser may recommend full compliance with the Act. In turn, this may impose a compliance burden in circumstances where a full prospectus or investment statement is not warranted.

4.3 Ancillary Provisions

Section 3 contains three other provisions that are relevant in considering whether an offer has been made to the public. The first is section 3(3) which provides:

> A person shall not be precluded from being regarded as a member of the public in regard to any offer of securities by reason only that he is a purchaser of goods from, or an employee or client of, or a holder of securities previously issued by, the issuer or any promoter of the securities.

This provision was designed to overcome previous decisions, local and overseas, that had held that offers made to persons with a pre-existing relationship with the offerer or promoter were not public offers. The fact that persons who have been issued with securities were shareholders or held securities from the issuer has been discounted in a number of cases in the light of section 3(3). For example, in *Re Dingwall & Paulger (in rec); Re Steel v NZ Guardian Trust Co.*[71] it was held that debenture stock which was "rolled over" was offered to the public when it was taken up by existing clients, officers and shareholders.

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71 Supra.

The second provision is section 3(5). This provision makes it simpler to prove an offer to the public by providing that proof of offer of securities to one person selected as a member of the public is prima facie evidence of an offer of securities to the public. Once this is shown then the onus is placed on the issuer to show that the exceptions in section 3(2) apply.

Section 5 (2CA) of the Act provides that a statement limited to stating that the issuer has the intention to offer securities to the public and providing no more than specified information is not an offer to the public. In addition, statements to a general meeting of the company or to the stock exchange for compliance with listing requirements are also exempted.[72]

4.4 *Ralston Purina* and the "Need to Know" Test

Section 3(1) is an inclusive definition of the term "offer to the public". Dr Gary Weiss in "The Concept of Public Offering under the Securities Act 1978" (1982) 12 VUWLR 105 argued that the NZSC and the courts in construing section 3 should have regard to a test formulated by the United States Supreme Court in *SEC v Ralston Purina Co*. In the United States, offerors are required to register a statement with the Securities and Exchange Commission (SEC) prior to securities being offered to the public. The Securities Act 1933 (US) provides exemptions for offers to either specified classes of persons or specified securities. One exemption is contained in section 4(2), which exempts "transactions not involving a public offering".[73] The term "public offering" is not defined in the Securities Act 1933 (US). The Court concluded that the application of the exemption turned "on whether the particular class of persons affected need[ed] the protection of the Act". The Court established a two limb test:

- Were the offerees able to fend for themselves; and
- Did the offerees have access to the kind of information which registration of the required documentation would disclose?

Since *Ralston Purina,* the courts and the SEC (through administrative guidelines) have further refined the framework within which a non-public offer may be made. The SEC has taken the view that public advertising is inconsistent with a non-public offer, as are investment seminars.

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72 Section 3(7).

Where offers are made to non-institutional investors there are a number of requirements in order for the exemption to apply. The first is that it is necessary that the offeree is provided with the information that would be available in a "full-fledged registration" statement. The second is that the offeree is "sophisticated with respect to business and financial matters generally", and may require specific experience of the particular industry depending upon the nature of the investment. The requirement for access to information is supplemented by a requirement that "each offeree must be provided with an opportunity to ask questions of the issuer and verify information through access to the issuer's books and face-to-face meetings."

The test focuses on the abilities of the offeree, and the position and relative knowledge of the offeree. Weiss states:

> The offeree's "need to know" has been accepted by the courts in the United States as the most important criterion in determining whether an offer is to the public. Under section 4(2) of the Securities Act 1933 (U.S.), the registration provisions of the Act need not be complied with in connection with any transaction by an issuer "not involving any public offering". The scope of the exemption under section 4(2) was considered by the United States Supreme Court in the leading case of SEC v Ralston Purina Co. The court considered that the exemption must be interpreted in the light of the purpose of the Act. In the court's view, the Securities Act was intended to protect investors by promoting full disclosure of information thought necessary to informed investment decisions. Thus, the applicability of the exemption depended on whether the offerees in question needed the protection of the Act. Accordingly, where an offer is made to persons who are shown to be able to fend for themselves and who, because of their position with respect to the issuer, have access to the same kind of information that a registration statement would disclose, such a transaction will be within the exemption under section 4(2).[74]

Weiss has discussed the application of this test to the Act. He comments:

> In the writer's view, the principal factor that the NZSC and the courts should adopt in determining whether a particular offer is to the public and therefore, subject to the registration provisions of the Securities Act, is whether the recipients of the offer in question need the information which a statutory prospectus would disclose in order to make an informed investment decision. Thus, an offering to one person only could be to the "public" if it is shown that person needed the protection of the Act. Equally, an offer made to a number of persons would not be an offering to the public if the offerees, by virtue of their position vis-a vis the issuer, have access to prospectus-

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73 See the discussion in Cox, Hillman, Langevoort, *Securities Regulation: Cases and Materials*, 3rd ed (2001), 383ff.

74 G. Weiss, op. cit., 113-4.

> type information about the issuer, and therefore, do not need the protection of the Act.[75]

Weiss' suggested approach has received a mixed reception from the courts in construing section 3. In the first case to consider this test, *Gardner*, Tipping J commented on this proposed test:

> There are some attractions in the "need to know" or "need for protection" approach to the construction of the expression offer to the public. This sort of approach would be in harmony with the basic purpose of the Securities Act 1978 in the present context … It is doubtful however whether as the legislation is presently drafted such a construction is reasonably open. It might also be thought to be substituting an approach which is little, if at all, more precise that the present concept of an offer to the public.[76]

When *Gardner* went on appeal, Hansen J also referred to Weiss' article and noted that the "need to know" test may be a consideration the court may take into account. However, when he came to the application of the tests he concentrated on whether the offerees were able to fend for themselves.

Hansen J did not explicitly consider the second test (that is, that by virtue of their position the offerees did not need the information), although for some of the offerees he referred to the fact that some were "close business associates, relatives or personal friends of Sir Robert Jones". Thus, it appears that Hansen J was considering these offerees' position vis-a-vis the issuer in the context of their relationship with Sir Robert Jones. As to the balance of the offerees, Hansen J described them as substantial shareholders, which may have been sufficient to warrant finding that there was compliance with the second test.

In *Ferguson,* counsel for Ferguson put forward the "need to know" test and suggested that "that the policy of the Act is to ensure that those that need to know the sorts of information required to be included in a registered prospectus have access to that information", and that as a result a person needs not only to be truly selected as an individual but also to have access to the information that would be required to be disclosed by the Act. This is clearly a wrong interpretation of the test if counsel was advocating the application of the test put forward by Weiss.

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75 Id, 114.
76 (1988) 4 NZCLC 64,412, 64,418-9.

Doogue J at first instance in *Kiwi Dairies* rejected the "need to know" test on the basis that there may be persons who come within section 3(3) and the section 3(2) exceptions "whom one would expect to be entitled to the advice which would be required by compliance with the Act in respect of offers to the public". Here Doogue J rejected, not the test put forward by Weiss, but a version of the test similar to that argued by counsel in *Ferguson* and accepted by Master Thomson.

In *Hyslop,* the Court of Appeal did not discuss the test referred to by Weiss, but the Court's judgment appeared to contain an implicit rejection of the application of such a test. More recently, *Ralston Purina* was argued before the Court of Appeal in *Kiwi Dairies* and Blanchard J described the decision as a "leading United States authority". However, no mention is made of the test formulated in that case for determining whether or not a person was a member of the public. (This is despite the fact it appears that counsel for the NZSC argued a version of this test.) While Blanchard J, in construing the phrase "close business associates" in section 3(2)(a)(i), stated that "it [was] unnecessary to go beyond the words themselves to find the legislative intent", he in fact propounded a test for this exception which required a "degree or intimacy or 'business friendship' … sufficient to overcome any inequality which might otherwise be present in the relationship". This appears to be a variant of the test from *Ralston Purina* in that "inequality" presumably appears to be intended to deal with the two limbs of the test - that is, that the relevant persons are able to fend for themselves and are capable of gaining access to the necessary information due to that relationship.

Accordingly, the "need to know" test has received a mixed reception from New Zealand courts. The Court of Appeal appears on one occasion to have implicitly rejected the test in *Hyslop*, and yet in *Kiwi Dairies* appears to be applying the test or a variant thereof. It appears that it is possible to argue the test, and that it may be a factor to be taken into account, but it is not a significant factor in the courts' analysis.

4. 5 Section Three: The Inclusive Definition

4.5.1 Section 3(1)(a) - "Any section of the public however selected"

Section 3(1)(a) provides that a reference in the Act to an offer of securities to the public shall be construed as including "A reference to offering the securities to any section of the public".

Section 3(1) is not an exhaustive definition. The aim of this provision is to overcome any notion that an offer must be a general one open to all. An offer, for example, made to all dentists in a particular town would come within section 3(1)(a) since the dentists would constitute a section of the public. As we have seen, section 3(1)(a) has a counterpart in the one of the exemptions in section 3(2)(a). Section 3(2)(a)(iii) exempts an offer to "Any other person who in all the circumstances can properly be regarded as having been selected otherwise as a member of the public".

The first case to appear before the court under section 3 and to consider the interrelationship of these two provisions was *Gardner*. RJI attempted to issue shares without registering a prospectus in late 1987. RJI wished to raise funds to provide capital for the purchase of a building in Sydney (the "Landmark"), and was concerned with the lack of institutional shareholders and the company's large number of small shareholders with small share parcels (some 35,000). Acting under advice RJI aimed its "Landmark" issue at institutional and other large investors. Shares were to paid by a ten-cent deposit on allotment, with the balance payable in December 1987. In order to avoid any impact upon the share price the shares were embargoed from sale for a period of two years from the time of allotment.

In order to ensure that no prospectus was required under the terms of the prospectus, the chairman sent a letter to Jarden & Company Ltd requesting that it arrange the deferred payment share placement on behalf of RJI and indicating that the company was only authorised to distribute an information memorandum on the share placement to persons who came within the terms of section 3(2)(a). After a period of time, persons who had heard of the issue approached RJI itself. In each case, before there was an allotment of shares the persons concerned were considered individually by Sir Robert Jones and the company secretary. They took into account that the individual was a current shareholder in the company, their knowledge of the person's reputation (including ability to repay), the broker's knowledge as well as in some cases, financial statements and information obtained from the person's financial advisers. They even went so far, in some instances, as to require that the existing shareholding be embargoed, and that RJI shares already held be placed as security for the amounts outstanding for the issue. Overall, RJI allocated 38.09 million shares to 39 parties on different terms as to price, amounts and restrictions. After the stockmarket crash of 1987 and the reluctance of some investors to pay substantial sums for shares which by now had dropped considerably in value the question of whether RJI could rely upon the section 3(2)(a) exceptions became a central issue.

Tipping J, at first instance, faced with the first judicial consideration of section 3, commented:

> … there is still the difficult task of reconciling the person who can in all the circumstances be regarded as having been selected otherwise than as a member of the public, with the primary provision that an offer of securities to the public includes an offer of securities to any section of the public however selected. As the learned authors Farrar & Russell in *Company Law and Securities Regulation in New Zealand* (1985) say at p354:
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>> 'There appears to be a logical contradiction in s3. Section 3(1)(a) defines offer of securities to the public as including an offer to any section of the public however selected, which is very wide wording. Section 3(2)(1) (sic) excludes certain persons including any person who in all the circumstances can properly be regarded as having been selected otherwise than as a member of the public. In other words the process of selection is irrelevant in s3 (1)(a) and relevant in s3 (2)(a)(iii).'
>>
>> A means of reconciling this apparent contradiction might be to say that sec 3(1)(a) is looking at the concept of a section of the public however selected, whereas sec 3(2)(a)(iii) is looking at an individual person or individual persons who have been selected not by reason of their being members of any section of the public, but truly as individuals.[77]

Tipping J pointed out that, taking into account section 3(3), it was clear that an offer to an existing shareholder would not per se exclude the offer from being an offer to the public. The fact that a small number of shareholders were involved did not stop the offer from being an offer to the public. The extra criteria used in selecting the offerees may have had the desired effect but as this was a summary judgement application Tipping J considered there was insufficient information to determine the matter. Having established the offer was prima facie an offer to the public the evidential onus, at least, fell upon the offerer to prove the offer came within the exemption.

When *Gardner* went on appeal, Hansen J agreed with Tipping J that the wording of section 3(1)(a) was so wide that it "was hard to envisage any offer that is not prima facie an offer to the public on the wording of the section". He suggested that if "the offer was limited institutions and directors, it may fall outside the term public, but, clearly, the term itself is very wide". He also commented that "once the company determined to widen the scope of the issue and discuss the matters with certain brokers and allow those brokers to approach appropriate clients, it seems to me that there is a prima facie offer to the public under section 3(1)(a)".

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77 *Gardner No 1* (1988) 4 NZCLC 64,412, 64,418.

Anderson J in *Orr v Martin* also cited Tipping J's approach with approval. In that case the offerors had placed advertisements and then had considered individual applicants on the basis of their business and management qualities. He held that in determining whether or not there had been an offer taking into account sections 3(1)(a) and 3(2)(a)(iii) it was necessary to look at the person whom were the subject of the relevant offer. As the offerors had advertised, it was necessary to consider all those who would have received the advertisement, not just those who took up the allotment of shares.

The Court of Appeal in *Kiwi Dairies* appeared to confirm Anderson J's approach. In this case Kiwi Dairies had placed an advertisement seeking deposits from shareholders in its newsletter. Doogue J in the High Court stated that he doubted that this exception could apply since in his view the offer was made to a class of persons rather than individuals from the class. The Court of Appeal considered that there was no evidence to indicate that selection had been made of persons otherwise than as members of the public since the offer was made to the class at large.

Accordingly, if a section of the public is targeted for an offer then this will be a public offer under section 3(1)(a) irrespective of how the section has been selected. In order to avoid this provision and be able to rely upon section 3(2)(a)(iii) it will be necessary to show that the focus was on an individual.

4.5.2 Section 3(1)(b) - "Offering securities to individual members of the public selected at random"

This provision is also aimed at preventing arguments based upon an offerer limiting an offer to particular individuals who are selected at random rather than offering to all. It is the compliment of section 3(1)(a), which includes within the term "public offers" offers made to certain "sections of the public". Section 3(1)(b) would catch offers to a number of persons who are selected on an even narrower or more specific basis (such as offers to persons who the offerer meets on the street at a particular time).

4.5.3 Section 3(1)(c) - "Known to the offerer as a result of any advertisement"

Section 3(1)(c) includes as an offer to the public the situation where a person becomes known to the offerer "as a result of any advertisement made by or on behalf of the offerer and that was intended or likely to result in the public seeking further information or advice about any investment opportunity or services". Although section 2 provides a definition for the term "advertisement" for the Act, the ordinary dictionary meaning is the relevant meaning for section 3(1)(c).

The courts have taken the term "offer" to have a broader meaning than such a term has in contract law, and have held that it would encompass invitations to treat. The courts have also taken a similar approach to section 3(1)(c). Anderson J in *Orr v Martin* stated:

> It is expedient to refer to sec 3(1)(c) to identify another category of prejudice to the public, which falls short of the concept of an offer of an offer in the law of contract. I have adverted to the contractual concept of offer and the lesser concept of invitation to treat envisaged by the expanded meaning of "offer" for the purposes of the *Securities Act* 1978.
>
> Section 3(1)(c) envisages an approach which is even less than an invitation to treat. It envisages an ordinary advertisement, which is made by or on behalf of an offerer that, was intended or likely to result in the public seeking further information or advice. In other words, it contemplates a teaser – an advertisement which is even less than an invitation to treat but which is likely to or intended to stimulate an inquiry about an investment so as to give rise to an opportunity to meet a likely investor. Again the point may be made that such expanded concepts are entirely consistent with the remedial nature of the Act itself.[78]

Fisher J in *DFC v Abel* was of the same view. He commented that "the offer to the public need not be, and in fact normally will not be, an offer in any contractual sense".[79]

Section 3(1)(c) does not require that what is advertised is an offer (or invitation to treat) of an investment opportunity. All that is necessary is that the advertisement is "intended or is likely to result" in investors seeking *further* information or advice about the investment. This issue arose for consideration in the *Culverden* case. The advertisement placed by Culverden referred specifically to the purchase of the units, the payment of a weekly fee for maintenance, insurance and outgoings etc, full security, and 24 hours staffing but did not refer to the buy-back provision (which was held by the court to constitute a security). In the High Court, Morris J found this to be an offer to the public. Morris J appeared to overlook the fact that investors had to be led to

78 (1991) 5 NZCLC 67,383, 67,390-1.
79 [1991] 2 NZLR 619, 626.

inquire about "investment opportunities". Morris J had expressly found that what Culverden was offering was not an investment opportunity since it did provide investors with a return in the form of interest or profit. However, on appeal the Privy Council found that the term "investment" encompassed schemes that provided more than a mere monetary return and that one had to have regard to the totality of benefits provided to the investor. The court found as a result that the Culverden offering was an investment. This means section 3(1)(c) may apply to advertisements that are intended or likely to result in investors inquiring about schemes promising returns comprising either monetary returns or a combination of monetary and non-monetary returns (even though the total return is less than the money originally outlayed).

In summary, section 3(1)(c) has the potential to characterise a large number of transactions as public offerings of securities. Once an advertisement is placed then this is the relevant "offer" to consider, even if ultimately a small number of persons are actually offered (in the contractual sense) securities for subscription. The failure to describe or refer to the securities or investment opportunity in the advertisement is irrelevant if the intention or likely result is that investors will inquire about information or advice about *any* investment opportunities. If a person who responds to the advertisement would "want to know more about the scheme and all rights and obligations under it" then this would appear to be sufficient to bring the advertisement within section 3(1)(c). The width of section 3(1)(c) is also extended by the broad definition given to the term "investment" by the Privy Council in *Culverden*.

Note, however, that an advertisement that complies with section 5 (2CA) of the 78 Act is specifically exempt from the application of Part II of the Act.

4. 6 Section Three: Definition by Exclusion

4.6.1 Section 3(2)(a)(i) - "Relatives or Close Business Associates"

Relatives

Section 3(2)(a)(i) provides an exception for offers to relatives. The term is defined in section 2(1). The Court of Appeal in *Kiwi Dairies* commented on this exception:

> … "relative" is given by s 2 the same meaning as in the Income Tax Act 1976, where it extends to persons connected by blood relationship, marriage or adoption as far as third or fourth degrees. This includes some quite distant relationships. In many families the bonds between persons so related may be slight or even non-existent. Nevertheless, the legislature must have regarded persons so defined as a class

> sufficiently closely connected on a personal basis with the issuer (who in this case obviously has to be an individual) that the assumption has been made that they would each have sufficient relevant knowledge of their relative's affairs, or the means of readily obtaining that knowledge.[80]

As of 1 April 2008, the term, "relative" has the same meaning as in the Income Tax Act 2007.

Close Business Associates

Prior to *Kiwi Dairies*, the second exception under section 3(2)(a)(i) had only been considered briefly in three High Court decisions.[81] In *Gardner (No 2),* Hansen J found that Hamilton and Bijl, two employees of a stockbroker, Egden Wignall (which had been used by RJI on a number of occasions to purchase shares for it) were "close business associates" of RJI. Hamilton had had a number of meetings with officers of RJI, including Sir Robert, about a range of matters involving the company. In addition, he had discussions about the placement of shares in the Landmark issue with appropriate clients of Egden Wignall. By contrast, the second employee, Bijl was the office manager for Egden Wignall and did not appear to have had personal dealings with officers of RJI. He invested jointly with Mr Hamilton. Nevertheless, Hansen J held that Bijl was in a similar position to that of Mr Hamilton.

Master Williams in *Barclay's New Zealand Limited v Gillies*[82] heard a summary judgment application based on an alleged contract for the issue of bonds to two employees of Caxton Paper Mills Limited, a client of Barclays which regularly dealt in bonds. These two employees, Gillies and Trott, along with a number of other persons, were invited to invest in a bond issue. One of the defences raised by these employees to Barclay's claim as financiers of the purchase was that the offer breached the Securities Act 1978. Master Williams rejected an argument that the employees were close business associates within the terms of section 3(2)(a)(i) as Barclays was not the issuer as defined in the Act (but merely the financier) and, in any event, the relationship was between Barclays and Caxton Paper Mills Ltd, not the two employees in their personal capacity. Master Williams stated:

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80 (1995) 7 NZCLC 260,828, 260,833 (CA).

81 *Barclay's New Zealand Limited v Gillies* (1990) 5 NZCLC 66,659; *Robert Jones Investment Limited*, supra and *International Standardbred Partnership v Garland*, supra.

82 (1990) 5 NZCLC 66,659.

> … the evidence from Mr Perkins makes it clear that the close business association referred to in that section was between Caxton Paper Mills and Barclays and not between [Barclays] and Messrs Gillies and Trott or both in their personal capacities. Certainly, instructions given to Barclays on behalf of Caxton were, it seems, almost always given by Messrs Trott or Gillies but that, in the Court's view, does not make Messrs Gillies or Trott "close business associates" of Barclays in their personal capacities.

The Court of Appeal subsequently overruled this finding in *Kiwi Dairies*.

In *International Standardbred Partnership v Garland*,[83] Garland had known Williams (who approached him about investing in a bloodstock scheme) since the late 1960s, and, had a number of business dealings with him as well as seeing him at occasional social functions. In addition, Garland at one stage during the 1970's had lent $20,000 to Williams. At an informal lunch investment in the bloodstock scheme was raised and as a result Garland signed a "Private Placement Memorandum" which included an acknowledgment that the offer was restricted to "close business associates of the Issuer and/or persons who for the purpose of their business habitually invest money and who have specifically requested particulars of this investment". Master Williams, who heard the summary judgment application, found that the plaintiff, who was pursuing Garland for outstanding fees, failed to satisfy him that there was no public offering of securities. He found that Garland was not a "close business associate" since he had not dealt with members of the partnership but rather with a person who was trying to sell interests in the partnership. In essence, this was a finding that he was not a close business associate of the "issuer".

The leading case on section 3(2)(a)(i) is *Kiwi Dairies*.[84] Kiwi was a company incorporated under the Co-Operative Companies Act 1949. In May 1992, it had 1,562 shareholders with issued and paid up capital of $1562.00. It had increased the number of shareholders by 31 May 1993 to 2,652 with issued and paid up capital of $14,567,173. The shareholders, together with other persons who were not shareholders, supplied dairy produce to Kiwi. Kiwi solicited deposits, upon which interest was paid, from shareholding suppliers through notices placed in a newsletter circulated to suppliers (including suppliers who were not shareholders). The newsletter contained

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83 (1992) 6 NZCLC 67,812.

84 See now *Dodge v Snow* (1999) 8 NZCLC 261, 803, where Master Venning held that an investor who purchased two tranches of shares was not a close business associate at the time of the purchase of the first tranche but was arguably a close business associate at the time of the purchase of the second tranche because at that time the investor plaintifff was involved in the business. See P Fitzsimons, "SMEs, Raising Equity Capital and the Securities Act" [1999] 5 C&SLB 67.

information related to suppliers' incomes, payouts, and details related to suppliers, areas of supply, quantity of milkfat and protein. The newsletter also dealt with issues related to management, plant, and financial systems. In addition, shareholders received information on the company (including its financial position) via the annual report and accounts of the company. By the end of April 1992 46 supplying shareholders had invested $1,954,697 and by 30 June 1993 the number of depositors was 115 with a total of $1,693,362 invested.

The NZSC considered that Kiwi was making an offer of securities to the public requiring compliance with the Act. In the High Court, Doogue J rejected the NZSC's suggestion that "close" was synonymous with "intimate" or "very near" on the basis that the legislature had used the term "close" and not the alternatives suggested, and he also found that each of the paragraphs of section 3(2)(a) were "clearly distinctive" and accordingly consideration of one could not aid the interpretation of another. Instead he held that:

> I do not see how the Court can be asked to place any particular gloss on the particular words used by the Legislature. The words must bear their normal meanings. It requires an investigation of the facts of the case to determine whether the relationship between the issuer and the recipient comes within those normal meanings.[85]

Doogue J's approach was to examine the arrangement as a whole and to concentrate upon the nature of the offerer company and the relationship in general terms between the company and the offerees. He accepted the argument that the relationship between a cooperative company and a supplying shareholder goes beyond the ordinary association of a shareholder in a company and he agreed with Kiwi on the basis of the different nature of a co-operative company. He found:

> [i]t difficult to see how there could be any closer business association other than a full partnership or an interlocking company structure than that between suppliers of a co-operative dairy company and that company. They are locked in a business association on a day to day basis as the information before the Court makes clear. The only rationale of the company's existence is to work for the benefit of the shareholder suppliers. They control the company. Their returns and the returns of other suppliers such as share milkers or other to the company are dependent upon the management of the company. It would be common knowledge that in many instances the livelihood of the suppliers is dependent upon the company. Their relationship is one of inter-dependence rather than dependence, as may be the case of an employee.[86]

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85 (1994) 7 NZCLC 260, 519, 260,525 (HC).
86 Id, 260,528.

As a result, Doogue J was prepared to find that section 3(2)(i) applied despite the fact that the offer was made to a large number of persons (who totalled more than the number required for the listing of a company on the New Zealand Stock Exchange) who had access to relatively limited financial information, and were not themselves necessarily persons who would habitually invest money.

In the Court of Appeal, Blanchard J considered the meaning of the "close business associates" exception in section 3(2)(a)(i). Kiwi argued that there should be an assumption that a close business associate did not need protection, while the NZSC argued that "the protective purpose of the Act should be of paramount importance". The NZSC argued for a narrow reading of this exemption so that:

> The class of close business associates ought not to be extended beyond persons who could fairly be assumed by reason of their closeness to the issuer already to be in possession of the financial and other information reasonably needed in order to evaluate the security being offered, or at least possessed of the means of readily accessing that information.[87]

Blanchard J accepted that the protective purpose of the Act was important but was of the view that it was not necessary "to go beyond the words themselves to find the legislative intent".[88]

Blanchard J held that the three words had to be considered in conjunction and glossed the meaning of the term in the following manner: first, the words "close" and "business" were "straightforward and require[d] no resort to dictionary definition".[89] Second, he noted that Parliament had decided to use the word "associate" rather than "association" and thereby "indicat[ed] that the focus of the exception is upon a connection of a personal nature between individuals, rather than upon a relationship with a corporate body".[90] Third, he considered the dictionary definitions of "associate" and noted that one definition spoke of "one who is frequently in company with another, on terms of social equality and intimacy; an intimate acquaintance, companion, mate".[91] Fourth, he emphasised that the Act spoke not of "associate"

87 [1995] 3 NZLR 26, 31 (CA).
88 Ibid.
89 Ibid.
90 Ibid.
91 Ibid.

but rather of “close associate” and held that “closeness involves nearness or intimacy”[92] - a view which had been expressly rejected by Doogue J.

Blanchard J construed the phrase as a whole and put forward the following test for determining if a person was a close business associate:

> Although an issuer and a holder of its securities have a relationship through business, the use of the terms “close” and “associate” requires more than this: there must be a degree of intimacy or “business friendship” in the relationship, though not necessarily a friendship away from business. It must be sufficient to overcome any inequality, which might otherwise be present in the relationship.[93]

Blanchard J considered this view of the phrase “close business associate” was reinforced by its grouping with “relatives” of the issuer in section 3(2)(a)(i). He thought the term “relative” indicated that, despite the fact that the bonds between some relatives “may be slight or even non-existent”:

> … the legislature must have regarded persons so defined as a class sufficiently closely connected on a personal basis with the individual (who in this case obviously has to be an individual) that the assumption could be made that they would each have sufficient knowledge of their relative’s affairs, or the means of readily obtaining that knowledge.[94]

The difficulty with Blanchard J’s test is that it requires an examination of the relative positions of the parties in the relationship and does not require an examination of the offeree alone. This requires determination of the existence of any inequality, the extent of this inequality, and whether or not it is overcome by the relationship, something that is more difficult to determine than the skills and abilities of the offeree alone. For example, an offeree who is not able to fend for him or herself (due to lack of general investment skills or knowledge) could still be a close business associate if the offerer's “friendship” was such as to overcome this deficiency. The emphasis on the relationship is supported Blanchard J’s subsequent statement that the “real test” is whether or not the offerees are “on close terms with the persons who are in control of the cooperative company, its directors and senior management”. Hence, Blanchard J did not require that the offerees have a certain level of commercial sophistication. The emphasis on the relative positions of the offerer and offerees is reinforced when Blanchard J considered the offer in this case. His Honour commented:

92 Ibid.

> A power imbalance in favour of the issuer does not preclude the possibility that an offeree is a close business associate but it makes the task of anyone so asserting appreciably harder.[95]

In *Kiwi Dairies*, the Court of Appeal made it clear that the special nature of any relationship between the offerer and the offeree (particularly where the offerer is a corporate body) will not assist the offerer if access to the relevant information is not available.

What is the meaning of "inequality" in Blanchard J's test? It appears that the main aspect of inequality to be examined is whether the offeree has access to relevant information about the issuer and its financial position. Blanchard J stated:

> It cannot be said that the relationship is sufficiently intimate that each individual shareholder can be taken to have ready access, should it be sought, to the up-to-date financial information about Kiwi which is required to appear in a short form prospectus ie. the information which a would-be investor needs in order to make an informed decision about the investment which is being solicited.[96]

Limiting "inequality" to access to information, which is relevant to determining the financial position of the issuer and details about the offering, is consistent with the broad statutory goal of the Act. The Court of Appeal in *Re AIC Merchant Finance* stated that this "is to facilitate the raising of capital by securing the timely disclosure of relevant information to prospective subscribers for securities" and "the best protection of the public lies in full disclosure of the company's affairs and of the security it is offering. [This] then allows the investor to make an informed investment decision, which in turn facilitates the functioning of financial markets".[97]

Limiting the "inequality" to information also takes into account the fact that if a prospectus were registered it would provide an offeree with certain information, but would not compensate an offeree for any relative lack of expertise, experience, wealth or intelligence. An offeree who comes within section 3(2)(a)(i) should not, in effect, have to be in a superior position vis a vis the offerer than an offeree who receives a registered prospectus. The phrase "any inequality otherwise present in the relationship" is capable of going beyond access to information and encompassing differences not only of expertise and experience, but also such elements as differences in intelligence. A lack of expertise, experience, wealth or intelligence would not be

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93 Id, 31-32.
94 Id, 32.
95 Id, 36.
96 Ibid.
97 *Re AIC Merchant Finance* [1990] 2 NZLR 385, 391-2 (CA) per Richardson J.

cured by the registration of a prospectus that conforms to the Act, as a person with a fairly modest degree of intelligence could invest in an offering on the basis of that prospectus. There still could be "inequality" present, particularly as there is no requirement for professional advice prior to a person taking up an offer.

Does Blanchard J's focus on "inequality" in the relationship between the offerer and offeree take into account the context in which the offeree considers an offer, such as the fact that an offeree was represented or received professional advice? The SEC "safe harbour" under Securities Act 1933, Regulation D, Rule 506, has a condition that the person has "knowledge and experience in financial and business matters so that the purchaser … is capable of evaluating the merits and risks of the prospective investment". This exemption is extended to unsophisticated investors who are represented by "an appropriate purchaser representative". In principle, if the offeree is represented and receives the necessary advice it would be appropriate that when determining the extent of any "inequality", the court should take account of the fact that the offeree has received advice.

In determining whether there is a sufficient relationship between the parties it is necessary to examine the persons with whom the offeree deals, as well as the nature of the dealings. Where the offeree deals with a corporate offeror it appears that the offeree has to have a relationship with the appropriate senior managers and this relationship has to include financial matters. Blanchard J stated, in the context of the fact pattern in *Kiwi Dairies*:

> The business activities just described [supplying milk, participation in bobby calf and veterinary clubs, and use of trading stores] are not of a nature likely to give rise to contacts through which the company and each shareholder can properly be described as close associates. The contracts which a farmer makes in the course of participating in these services - selling milk and calves, caring for stock, purchasing goods from Kiwi's stores, making mortgage payments - would not normally involve senior management or members of the board. The day-to-day contracts are with middle management or below and unrelated to Kiwi's overall financial position.[98]

In his earlier discussion of section 3(2), Blanchard J had indicated that the offerer needs to show "something else" in order to make an offer to a shareholder a non-public offer in the light of section 3(3). Clearly, the mutual commitment of the company and the supplying shareholders and the source of income were not sufficient to be considered as the "something else" which made this a non-public offer. Blanchard J accordingly reached the clear view that all of the

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98 [1995] 3 NZLR 26, 35 (CA).

supplying shareholders were not close business associates of Kiwi and that Kiwi Co-op should have complied with the Act, or sought an exemption from the NZSC.

In summary, the *Kiwi Dairies* test for the existence of a close business associate is:

- Is the relationship sufficiently intimate that it overcomes any inequality in the relationship?

This question is answered by determining if:

- Where the issuer is a company, the relationship is with those persons who control the offerer and the nature of the dealings between the parties is more than those of an ordinary trading nature;

- From the relationship with the offeror or appropriate officers of the offeror, is the offeree able to access the required information if it is sought?

In *Kiwi Dairies*, Blanchard J referred to information being available "should it be sought". Accordingly, it is not necessary that the information actually is provided to an offeree; it is sufficient if it is available. What information should be provided to an offeree? The provision of the annual financial accounts to shareholders and the publication of "further information" in Kiwi's newsletter were clearly insufficient. Blanchard J described the information that should be disclosed as:

> … *Up-to-date financial information* about Kiwi which is required to appear in a short form prospectus ie the information which a would-be investor needs in order to make an informed decision about the investment which is being solicited.[99]

A short form prospectus is provided for under Regulation 4, Securities Regulations 1983 as amended.[100] This exempts an offerer from having to register a "full prospectus" with the information required under Regulation 3 if a number of conditions are fulfilled. The financial information required to be disclosed includes a copy of the most recent audited financial statements of the issuer (R. 4(1)(c)), details relating to the issuer and the securities being offered, a statement as to the trading prospects of the issuer, the amount of any issue expenses, all terms of the offer and terms of the securities being offered (R. 4(2)(a)) assuming that equity securities

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99 Id, 36.

100 The information required under regulation 4 may be altered if The Securities Act (Short Form Prospectus) Exemption Notice 1996 (SR 1996/318) applies. Regulation 4 was amended in part by Regulation 5, Securities Amendment Regulations 1997.

are being offered, a statement of financial performance and a cashflow statement if an interim balance sheet is provided (R. 4(2)(e)).

Regulation 4(2)(f) also requires a statement by the directors, after due inquiry, as to whether there are any circumstances that have arisen since the date of the last statement of financial position which would adversely affect the trading, profitability or solvency of the issuing group. At first glance, it is not clear whether or not this statement would be considered as "financial information". However, Blanchard J, referring to the information that was in fact provided to the supplying shareholders by Kiwi, stated:

> A noticeable deficiency in the financial information in the hands of supplying shareholders when they received the newsletters soliciting deposits was the lack of any statement from directors about whether there had been any post-balance date circumstances adversely affecting trading, profitability, value of assets or the ability of the Kiwi group of companies to pay its liabilities: reg 4(2)(f) of the Securities Regulations 1983 (SR 1983/120). That regulation sets out the matters to be stated in a short form prospectus where an offer of securities is made to persons who already hold securities in the issuer.[101]

In dealing specifically with section 3(2)(a)(i), Blanchard J cleared up one contentious point. This subparagraph allows an offer where the offeree is a close business associate of the *issuer*. If the issuer and the offeree were individuals then, provided there is the requisite relationship, the exemption would apply. However, a literal reading of the exemption would cause problems where either the offerer or the offeree was a company as it is difficult to see how one could be "intimate" with a body corporate. Master Williams in *Gillies* rejected an argument that there was a close business association between a financier and the employees of a company in their personal capacity, although he appeared to be prepared to accept that two corporate bodies could be "close business associates". Hansen J in *Gardner (No 2)* was prepared to find that individual offerees were close business associates of Sir Robert Jones, although the offerer was RJI Investments Ltd.

Blanchard J dealt with this issue in *Kiwi Dairies*. His Honour held that:

> Where the issuer is a body corporate an offeree can still be regarded as a close business associate if those individuals who control the issuer have an intimacy of business contact with the offeree (or, where the offeree is a corporation, with those individuals who control the offeree). By "control" in this context we are referring to the holding of a position in an issuer, which properly enables the dissemination of

101 [1995] 3 NZLR 26, 29.

> corporate financial information, and the corresponding position in a corporate offeree.[102]

The approach is apt. One of the original aims of the Act was to do away with a distinction between entities which were offering investments to the public and concentrate upon regulating the actual offering of securities to the public irrespective of the type of entity making the offer. If section 3(2)(a)(i) was applied literally then there might have been more exemptions available for those offering debt or participatory securities (since these could be offered by an individual) than for those offering equity securities (which requires a corporate body as the issuer except for non-exempt previously allotted securities). *Kiwi Dairies* finding on this issue legitimates the approach of Hansen J in *Gardner (No 2)*, as Sir Robert Jones clearly would have been in a position to disseminate financial information, and, overrules the finding in *Gillies* on the point.

Relatives or close business associates of the issuer *or of a director of the issuer*

The italicised words were added in 2004 and became effective on 15 April 2004. They appear to have been added to give legislative certainty to the overruling of *Gillies* by *Kiwi Dairies* on the question of whether the requisite relationship is with the company issuer or a director of the company issuer.

4.6.2 Section 3(2)(a)(ii) - "Habitual Investors"

Section 3(2)(a)(ii) provides a further two exceptions. It excepts persons whose principal business is the investment of money and persons who, in the course of and for the purposes of their business, habitually invest money. No definitions are provided in the Act for these exceptions. These exceptions can be of greater importance to an offerer since they comprise a group of people who would be larger than the potential number of persons included in section 3(2)(a)(i).

Two cases have considered this provision. Both arose out of RJI's Landmark Issue. In *Gardner (No 2),* Hansen J considered RJI's offer to a number of selected persons, including institutions. He held that a stockbroker's nominee company was within the habitual investor exception. A more difficult issue was whether Mr Gardner came within this exception. Hansen J was satisfied that Gardner (who prior to subscribing 500,000 shares in the Landmark Issue already held some 500,000 shares in RJI), was an habitual investor given the evidence:

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102 Id, 32.

> … regarding Mr Gardner's activities in 1986 and 1987; the large number of shares he purchased; [and] his statements that he was a share market trader and dealer.[103]

Hansen J went so far as to say that the other individual investors who held in excess of "50,000 Robert Jones shares" were, in his opinion, "substantial investors", which appeared to mean that he viewed them as "habitual investors".[104]

However, when this share issue was reconsidered in *Ferguson,* Master Thompson took the view that Mr Ferguson, who must have been one of the other individual investors considered by Hansen J, was not an habitual investor even though Ferguson:

> [W]as self-employed, and while he appeared to have no earned income, was clearly a substantial investor; he had blue chip shares worth $2 million together with other substantial assets. At the relevant time he owned in excess of 100,000 RJI shares; he wished to increase that holding to 500,000 RJI shares and was willing to enter into a deferred purchase agreement to buy RJI shares.[105]

Master Thomson required more than an examination of the person's assets, including share holdings. He stated:

> However, its seems to me very arguable that, because a person is shown to be a substantial holder of shares and appears to live off investment income, it does not follow that the Court must find that such person is necessarily a share market trader and dealer. One cannot exclude the possibility that a substantial part of his holdings may have been acquired by gift or inheritance, or that the bulk of the estate consists of a few large investments made over a lengthy period of time.[106]

Whether or not a person is a habitual investor is a question of fact in each case. Clearly, institutional investors will come within that term but whether any particular individual investor does is less clear. The difficulty for those seeking small amounts of capital is that normally institutional investors will prefer to invest in larger, listed vehicles. An offerer will have to distinguish between a "person" who merely relies on investment income for a living, and an "habitual investor" who is exempt under section 3(2)(a)(ii). It appears that some of the criteria include the value of the person's assets, but also the composition of the assets, how they were acquired, and perhaps how actively the person trades.

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103 *Gardner (No 2)*, 68,532.
104 Ibid.
105 (1995) 7 NZCLC 260,668, 260,674 (HC).
106 Ibid.

These questions are moot given the insertion of new section 5 (2CB). This is because a properly advised issuer will seek to attract the section 5 (2CE) exemption (the experienced person exemption). To this extent, this exclusionary paragraph is now redundant.

4.6.3 Section 3(2)(a)(iia) – Offers to persons who are required to pay a minimum subscription price of at least $500, 000 before allotment

This subparagraph of section 3(2) became effective on 15 April 2004. It appears to be based on section 708(8)(a) of the Corporations Act 2001 (Cth.). The Australian provision states that the relevant offer does not require disclosure if the minimum amount payable for the securities on acceptance of the offer by the person to whom the offer is made is at least $500,000. However, note that the wording of the Australian provision differs and appears within section 708(8) which deals with sophisticated investors. New Zealand now provides for sophisticated investors by way of a new exemption in section 5 (2CE) of the 78 Act. What is the relationship between the provisions in the New Zealand regime? The practical operation of this new subparagraph may be explained by saying that subparagraph (iia) merely excludes the *offer* from the application of section 3 of the 78 Act. In this way, for example, it facilitates private placements. However, a properly advised issuer would only accept an acceptance made pursuant to such an offer where the exemption in section 5 (2CB) was applicable.

4.6.4 Section 3(2)(a)(iii) - Offer to a person selected "otherwise than as a member of the public"

Section 3(2)(a)(iii) potentially provides the broadest class of persons to whom an offer can be made without having to comply with Part II of the Act. It does not rely upon a prior relationship (as in section 3(2)(a)(i)), nor does it require that the persons to whom the offer is made have experience in the investment of moneys (as in section 3(2)(a)(ii)). All it requires is that the person have been selected otherwise than as a member of the public.[107] As those who have

107 See *Dodge v Snow* (1999) 8 NZCLC 261, 803 (parties met socially through a church and family connection and hence arguable that investor selected otherwise than as a member of the public) and *Cowles v Syndicated Investigations Ltd* (1998) 8 NZCLC 261,581 and P Fitzsimons, "SMEs, Raising Equity Capital and the Securities Act 1978" [1999] 5 C&SLB 67, 69.

attempted to rely upon this provision have found, this appears to be deceptively simple. In fact, it is perhaps the most difficult of the exceptions upon which to rely.

Four preliminary points can be made about section 3(2)(a)(iii). First, the approach to this provision appears to be subjective; that is, from the point of view of the offerer. Second, this provision provides for a distinct class of persons from those set out in section 3(2)(a)(i) or (ii). Third, section 3(2)(a)(iii) is distinguished from section 3(1)(a) on the basis that section 3(1)(a) is dealing with the selection of a *section* of the public, while section 3(2)(a)(iii) is dealing with how a particular *person* was selected. Where an offerer uses an advertisement to show the availability of an investment opportunity the courts have viewed the advertisement as the offer to a section of the public and, therefore, within section 3(1)(a) notwithstanding that the persons who actually are allotted shares are considered on their individual merits. Fourth, the matters that the court can consider under this provision are broad. Hansen J in *Gardner (No 2)* rejected a submission that certain facts were irrelevant to the court's consideration of the issues.

In *Gardner (No 2)*, Hansen J considered whether an offer of shares came within the exceptions in section 3(2)(a). After the summary judgment application, Mr Gardner was adjudicated bankrupt which made continuation of the proceedings by RJI of little value. However, as Mr Gardner had paid a $50,000 deposit for the shares the Official Assignee decided to pursue Mr Gardner's counterclaim for the return of this deposit. Hansen J found that the offerees came within the exceptions. The factors that Hansen J relied upon in finding that section 3(2)(a)(iii) in particular applied included the very small number of allotments made (only a few of which were to individuals), the turning away by RJI of a large number of enquiries from the public (including persistent applicants), there was no automatic right of participation, the applicants were individually checked, the financial standing of the applicants, the embargoing of the shares by applicants, the terms of each contract were individually negotiated, and that there was no advertising of the issue. In addition, Hansen J took into account the fact that "on a need to know" basis all the participants received professional advice. One factor that he felt went against these factors was that approaching brokers "lent a possible public aspect to the matter".

Hansen J summed up his findings as follows:

> Overall, having balanced all these competing factors, I am satisfied this was not an offer to the public, and all those that were allotted shares fall within the exemption provisions of sec 3(2)(a). The initial allotment was clearly to institutional investors and to close business associates, relatives or personal friends of Sir Robert Jones. Allotments to Mr Hamilton, Bijl and Jonstock Nominees have already been dealt

> with. As to the balance of the individuals for whom evidence has been given, they were all substantial shareholders in RJI. They all dealt through brokers, and had the opportunity of professional advice. They were in a position to agree to "lock up" their shares for considerable periods of time, which carried with it the inference of a substantial financial state. They were individually considered. I am satisfied they were selected truly as individuals, and not as members of the public.[108]

Hansen J placed significant weight on the individuality of the process in terms of consideration of the applications, the terms negotiated, and the financial position of the applicants. RJI clearly went to considerable lengths to follow an individual selection process in making this issue. However, when the same share issue was considered in *Ferguson*, Master Thomson discounted Hansen J's findings. Ferguson was seeking a summary judgment for the recovery of the $10,000 he had paid as a first call for 100,000 RJI shares in the Landmark issue as well as the proceeds of sale of 27,458 shares, which had been held by his sharebroker as security for the balance owing for the share issue. RJI responded by seeking summary judgment for the amounts outstanding for the share issue after the sale of the secured shares. In relation to the smallness of the group Master Thomson emphasised that the size of the group offered shares was not determinative. The mere fact that there was no automatic right of participation in his view did not mean that the offer was not made to the public. He also considered that the special terms of this issue (that the shares be embargoed for a particular period) did not advance the argument that the offer was not a public one, and that the imposition of individual terms was not something that could distinguish a public one from a private one on the basis that the same technique was used in relation to the sales of cars to the public. He also suggested that Hansen J had not considered all the investors' individual situations in depth and thought that this "may" be necessary before finding that the issue was not an offer to the public. Master Thompson's criticisms of Hansen J's findings overlook the fact that Hansen J had considered a dozen factors together. By contrast, Master Thomson isolated four factors and considered them individually. As section 3(2)(a)(iii) requires a consideration of "all" the factors, (the approach taken by Hansen J), Master Thomson's selective criticisms seem wrong as a matter of statutory construction.

Several other cases have considered this provision. One of the first was *Kepler Developments Ltd (in rec) v Stanway.*[109] In a summary judgment application, Master Hansen held that the founding shareholders and the promoters of a company had failed to establish an arguable defence that

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108 (1993) 6 NZCLC 68,514, 68,533 (HC).
109 (1988) 4 NZCLC 64,690 (HC).

they were members of the public for the purposes of the Act.[110] In *Re Pan Austral Corp Ltd*, Gault J held that an offer of shares "to a small and defined list of creditors" pursuant to a scheme of arrangement under s 205 of the Companies Act 1995 would not be one made to the public.[111]

The most significant case to consider section 3(2)(a)(iii) is the Court of Appeal decision in *Hyslop*. Richardson J considered that Mrs Hyslop and the other offerees were not persons who had been selected at random in terms of section 3(1)(b), nor had they become involved through an advertisement which removed the need to consider section 3(1)(c). He then turned to section 3(1)(a) and commented:

> Reading s 3(1)(a) and s 3(2)(a)(iii) together I consider the proper inference is that those solicited were not selected as a section of the public. Rather they were approached as private individuals because they were old friends. Approaches to relatives and close business associates are excluded under s 3(2)(a)(i). Even if, contrary to my assessment, the six old friends of Mr Langdale could regarded as a section of the public, I would hold that they were selected otherwise than as members of the public.[112]

McKay J's approach to the construction of these provisions was similar in that he found that Mrs Hyslop was not a member of the public since "an offer [was] made to her as an individual, and she had not been selected at random", and that "she was approached as being a long-standing friend of Mr Phillip Langdale".[113] *Hyslop* can be contrasted with *Re Dingwall & Paulger* where the company, since the 1930s, had:

> ... [t]aken cash deposits from its shareholders and employees and treated them much as a banker would. The funds earned interest and were repayable on demand. People came to learn of the scheme by word of mouth from family and friends or fellow employees. The existence of the scheme was never advertised or publicly notified. By 1984 there were some 350 depositors to a total value of perhaps $350,000.[114]

Ellis J was faced with the issue of whether or not there had been an offer to the public. He considered whether or not the depositors were members of the public for the purposes of section 3 and he stated:

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110 Id, 64,693.
111 (1990) 3 BCR 500 (HC).
112 [1993] 3 NZLR 135, 142 (CA).
113 [1993] 3 NZLR 135, 152-3.
114 (1990) 5 NZCLC 66,780, 66,782.

> … counsel was unable to formulate the selection of depositors without including such categories as 'friends and neighbours'. This in my view cannot properly be regarded as a selection otherwise than as a member of the public.[115]

One way to distinguish this case from *Hyslop* is the significant difference in the numbers of persons involved and, perhaps, the inclusion of "neighbours" which might be taken to be a class of persons who would come within section 3(1)(a).

Although section 3(2)(a)(iii) appears to be the widest of the exceptions under section 3(2)(a), it is the most difficult to apply as the courts have not enunciated clear criteria as to what constitutes "individual selection". Approaching limited numbers of old friends is one criterion. However, a selection process that tries to select people on an individual basis from a larger group of people (for example, applicants for a share issue) or respondents to an advertisement is less certain. The most recent pronouncement on the point is *Lawrence* (see above), where the Court of Appeal held that application of the sub-paragraph was an objective question of fact. Despite pronouncements to the contrary, the logic of *Lawrence* is that *Hyslop* was wrongly decided.

In any event, recent amendments to the 78 Act appear to have rendered this subparagraph redundant. This is because an offer contained in a section 5 (2CA) advertisement is exempt from the provisions of Part II (except sections 38B and 58). Well-advised issuers will rely on this exemption to publicise the offer and "test the waters".

4.7 Conclusions

One measure of the internal coherence of legislation is the degree of "fit" between purpose (legislative or strategic intent) and practice (judicial interpretation or strategic implementation). The purpose or strategic intent of the existing legislation can be discerned in the body of discourse surrounding the introduction of the 1978 Act, namely, investor protection by way of timely disclosure of information so as to enable investors to make informed, but not riskless, choices. The tactical means of achieving this strategy was to focus on the *activity* of fund raising generally - regardless of the type of entity used as a vehicle for such activity. The 1996 amendments to include fund raising by superannuation schemes, unit trusts and life insurance within the ambit of the Act can thus be read as a continuation of that purpose, an extension of the

115 Id, 66,790.

coherence of the regime. Further, it was intended that key definitions, such as the definition of a security, were to be widely defined and so interpreted by the judiciary.

The 1978 Act is thus the legal expression of an ascertainable policy (strategy) and purpose (strategic goal).[116] When encountering the Act in practice, the judiciary possess a set of legal tools by which they may unlock meaning to achieve the desired fit between purpose and practice (making the Act work as intended). These tools comprise doctrines of statutory interpretation expressed in common law, the 1978 Act itself, and, the Acts Interpretation Act 1924. As argued earlier, an application of these tools to the definition of a security in the Act provides clear guidance as to the interpretation of the term. It is striking to note that the "problem" cases (*Smith* and *Marac*) are both cases where *the Court made no reference* to the purpose of the legislation. However, a strict application of the doctrine of precedent now means that Courts in New Zealand *must* take into account the purpose of the legislation since there is now a decision of the full Court of Appeal in *Kiwi Dairies* and an advice of the Privy Council in *Culverden* to that effect. Viewed this way, *Smith* and *Marac* are cases of underreach, now cured by decisions of courts higher in the appellate chain.[117] In the result, there appears to be a coherent fit between the purpose of the legislation and the practice of the courts on the interpretation of a security. This has been achieved by reading the definition widely, as parliament intended, and by a ruling (specifically in *Kiwi Dairies*) that the purposes of the legislation must be considered by a court. The definition of a security problem thus becomes an example of the evolving application of judicial discretion and the doctrine of precedent culminating in a definitive ruling by a court high in the appellate chain. Here, application of traditional doctrines enabled the discovery of the correct interpretation largely because the statutory definition itself was highly transitive. By contrast, the wording of section 3 is, in part at least, intransitive. This implies (but does not prove) that the exercise of judicial discretion is less likely to produce a coherent reading of the section. But the real problem with section 3 consists of a built-in design flaw, the nebulous concept of "the public".

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116 See generally, G Walker, "Law as Strategy: Introductory Concepts" (1999) 17 C&SLJ 467.

117 It may be that *Culverden* is a case of overreach insofar as the advice of the Privy Council extends the reach of the securities regime into the traditional realm of real property law (freehold title to land). Whatever views one might have on this point, it can be expected that the practice of the retirement home industry will be to seek an appropriate exemption or adjust the legal form of the particular purchase agreement to exclude the ambit of the securities regime. As of December 1998, the New Zealand Law Commission was proposing a Retirement Villages Act to deal with the issue. See CCH, *New Zealand Company Law and Practice –Report Summary No 198* (21 December 1998), 4; D Dugdale, "Retirement Villages" [1999] NZLJ 357. See now The Securities Act (Retirement Villages) Exemption Notice 1999 (effective 28 January 1999).

Section 3 of the Securities Act 1978 is an evolutionary maladaptation. The evidence produced in Part IV shows that the courts had great difficulty with the concept of "the public" prior to the 1978 Act. The next logical step was to dispense with the concept and replace it with a general prohibition and clearly defined exemptions (precisely the solution adopted by the Australian legislation). Instead, the 1978 attempted to define the term in section 3. The attempt was doomed to fail as the early case law on section 3 illustrates. Further, while the decision in *Kiwi Dairies* has clarified some of the problems in section 3, it also serves to confirm its design flaws. One reiterated example will suffice: an offer will be caught by section 3 (1) unless all the persons to whom the offer was made come within section 3 (2). Thus, one misjudgment in the offering process will avoid the entire issue. This is objectionable on a number of counts. First, a law concerned with capital formation should be easy to understand, efficient and certain. Such a proposition applies, *a fortiori*, to a small capital importing country such as New Zealand given well-known domestic constraints on capital formation and intense international competition for capital. Second, uncertainty causes inefficiency. Generally, if legislation lacks clarity then costs will result. Ramsay[118] has listed some of these costs as follows: increased legal research costs;[119] litigation costs;[120] judicial system costs;[121] increased unlawful activity;[122] decreased lawful activity,[123]and discrimination.[124]

In terms of securities legislation, the uncertainty surrounding the concept of offer to "the public" creates difficulties for practitioners advising on compliance with securities law. In the result, those seeking to raise capital may be faced with the costly option of erring on the side of caution and registering a prospectus when it may not be necessary,[125] or carrying out extensive

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118 I. Ramsay, "Corporate Law in the Age of Statutes" (1992) 14 Syd. LR 474, 482 following G. Maggs, "Reducing the Costs of Statutory Ambiguity: Alternative Approaches and the Federal Courts Study Committee" (1992) 29 Harv J Leg 123, 126-30.

119 Much legislation, particularly in the area of corporate law, requires expenditure on legal research costs, such as legal opinions for lawyers, in order to obtain clarification.

120 Legislative ambiguity promotes litigation in order to obtain clarification.

121 By promoting litigation, legislative uncertainty requires expenditure on judicial resources.

122 Legislative ambiguity may result in persons or companies unwittingly breaching the law because the ambit of the law is not clearly marked.

123 Legislative ambiguity may chill lawful and productive activity by reason of the fact that persons or companies may not enter transactions because the precise ambit of the law cannot be determined.

124 A lack of clarity may mean that legislative implementation by a regulator is undertaken on an arbitrary or discriminatory basis.

125 G. Walker and M. Fox, "Costs Associated with Initial Public Offerings on the New Zealand Stock Exchange," [1995] 3 ICCLR 106. The authors concluded (after a study of 20 companies making IPOs) that average fund raising compliance costs were 4.29 per cent of total funds raised. Interestingly, costs did not vary much between large issues and smaller issues. Hence, the proportion of compliance costs to funds raised was higher for smaller issuers. See also Morel and Co., *Securities Act Study - A Report prepared for*

investigations into potential offerees to ensure they come within the exemptions.[126] Although it may be possible to rely on a narrow band of people under the section 3(2)(a)(i) and (ii) exemptions, this is unlikely to provide a sufficiently large pool of potential investors.[127] Further, in the case of small companies, large institutions and habitual investors may decline to infuse equity unless they gain control. This has chilling effect business start-ups.[128]

Rather than risk incurring prospectus costs or penalties for non-compliance, many companies (especially small ones who are less able to sustain such costs), may opt to raise debt capital through finance companies (even if this is inappropriate to the stage of growth of the company and leads to cashflow difficulties).[129] This limits not only those firms but also the economy as a whole as it seeks to capital to grow and compete with overseas competitors.[130] This highlights an even more troubling problem. The "offer to the public" concept simply does not fit with the realities of the New Zealand economy. It is well documented that 99.5 per cent of all businesses in New Zealand are SMEs, which employ 76.8 per cent of the total labour force and have difficulty raising equity capital.[131] Section three of the Securities Act seems to operate in ignorance of these facts. The offer to the public concept may be appropriate to the 0.5 per cent of large businesses in New Zealand but is totally inappropriate for SMEs who cannot afford the time or expense associated with a formal public offering.[132] There is hence a need for better fit between securities regulation and the economic characteristics of the New Zealand economy.

The solution to the evolutionary maladaptation of section 3 is extinction - the replacement of section 3 with a general prohibition on offering securities without a prospectus, subject to certain statutory exceptions. A model, which New Zealand legislators could work from, is the Australian Corporations Law.[133] Under the Corporations Law, the concept of offer to the

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the Ministry of Commerce (1994). This inquiry into fundraising by unlisted companies found that key reasons for not issuing a prospectus were cost and complexity. There was a consensus amongst companies surveyed that raising $1 million by a public issue with a prospectus cost about $120,000 (ie., approximately 12 per cent of funds raised). Id, 2.

126 P. Fitzsimons, "Capital Raisings and Offers to the Public" (1995) 1 C&SLB 4, 10.

127 The venture capital industry in New Zealand is small.

128 Morel and Co., *Securities Act Study - A Report prepared for the Ministry of Commerce* (1994), 11-12.

129 Ibid.

130 P. Fitzsimons, "Capital Raising and Offer to the Public" (1995) 1 C&SLB 4, 10.

131 R. Lingard, *Where has all the Capital Gone?* (unpub M. Comm. Thesis, Dept. of Management, University of Canterbury, December 1998), presents the recent data. See also A Cameron and C Massey, *Small and Medium-sized Enterprises : A New Zealand Perspective* (Auckland: Longman, 1999).

132 See G. Walker and M. Fox, "Closing the Loop: SMEs and Securities Regulation" [1999] NZLJ 275.

133 See generally, M. Taylor, "Capital Raising in Australia" in G. Walker, Gen. Ed., *Securities Regulation in Australia and New Zealand* (2nd ed., 1998) 289.

public, which appeared in the Companies Code, has been removed and replaced by an overall prohibition on inviting or offering securities for subscription or purchase without a prospectus. The basic prohibition is contained in section 706. The most significant exemptions are the small scale offerings exemption contained in section 708(1) which allows for 20 issues or sales in 12 months, to a ceiling of $2 million, and the 'sophisticated investor' or 'gold card' exemption which applies to an offer where the minimum subscription is A$500,000 by each person to whom the offer or invitation is made: section 708(8). Both exemptions avoid any inquiry as to the meaning of the public.

Replacing section 3(2)(a)(iii) with the Australian small scale offerings exemption presents as an immediate solution to the present problems surrounding the New Zealand section. If we view section three as a maladaptation, however, the only logical solution is extinction followed by a leap to the next evolutionary stage as manifested in the Australian legislation. More generally, the "offer to the public" highlights an urgent need for strategic thinking about securities regulation in New Zealand. The type of thinking required is well illustrated by the first major strategic review of New Zealand, the *New Zealand Porter Report*.[134] The major finding of that report was "a misalignment between the structure of the New Zealand economy and … today's global economy."[135]

4.8 Private Placements and Confidential Offers

In an attempt to avoid the registration requirements under Part II, offerors have on occasion required the offerees sign a document that states they are persons who are close business associates or habitual investors in an attempt to come within section 3(2).[136] Two sections make such attempts difficult. The first is section 4, which provides that the provisions of the Act cannot be contracted out of by the parties so an attempt to agree that the Act would not apply to an offer of securities would not be successful.[137] The second is contained in the last three lines of section 3(1). This provides that an offer to the public includes the matters set out in section 3(1)(a)-(c) "whether or not any such offer is calculated to result in the securities becoming

134 G. Crocombe, M. Enright and M. Porter, *Upgrading New Zealand's Competitive Advantage* (1991).
135 Id, 147.
136 For example, see *International Standardbred Partnership v Garland*, supra.

available for subscription by persons other than those receiving the offer". As Tipping J in *Gardner* stated, the "last three lines of sec 3(1) are obviously designed to reverse the law as it stood in terms of sec 63(2) of the Companies Act 1955 and it is therefore immaterial that the offer was not calculated to go wider than to the group to whom it was made".

The courts have also taken a substance over form approach to attempts to limit an offer to persons who are not members of the public. In *Kiwi Dairies*, Doogue J in the High Court held that tagging a newsletter addressed to shareholders with the words "strictly confidential - not for publication" made no difference to whether or not the Act applied. Similarly, in *International Standardbred Partnership v Garland*, Master Williams held that there was an offer to the public despite the subscriber being required to sign a "private placement memorandum" in which he "acknowledged" that he was a close business associate of the members of the bloodstock partnership and an habitual investor.[138]

As of 2004, however, New Zealand has a "safe harbour" private placement exemption via sections 5 (2CA) through 5 (2CF) of the 78 Act. Thus, section 5 (2CA) provides a safe harbour for advertising and "testing the waters" (i.e. ascertaining investor interest) and section 5 (2CB) enables placement to "eligible persons" (i.e. wealthy or experienced investors).

4.9 Void Irregular Allotments of Securities: Section 37 of the Securities Act 1978

Public offerings of securities are regulated by Part II of the 78 Act. In broad terms, Part II of the Act achieves its aims in three main ways. These are:

- A prohibition on offering securities to the public without a registered prospectus (section 33) and allotting securities without a registered prospectus (section 37).
- Requiring compliance with the relevant provisions and regulations dealing with the disclosure of information if a public offering is made.
- By imposing liability upon issuers or the directors where offers or allotments are made in breach of the Act or for misstatements or fraud in relation to a registered prospectus.

This section examines the implications of allotting securities without a registered prospectus in breach of section 37. Breaching section 37 not only impacts on the issuer and the directors but may also have serious consequences for third parties, such as lenders, who are involved in some

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137 See *Re AIC Merchant Finance Ltd (in rec); National Mutual Life Nominees Ltd v Watson* [1990] 2 NZLR 385.

way with a non-complying public offering and even subscribers themselves who may have entered into contracts with third parties. Note that section 37 was overhauled in 2004 in order to establish new procedures for the validation of void allotments of securities.

4.9.1 Outline of section 37

Allotments made in breach of section 37 are invalid and of no effect: see section 37(4). An offer or allotment of securities in breach of the Act may result also in criminal liability under section 59. Section 59 provides that "if an offer of a security is made to the public, or a registered prospectus relating to a security is distributed, or a security is allotted, in contravention of this Act" then the issuer, the directors and any promoter may be criminally liable for the contravention.[139] In addition to criminal liability, section 37(6) of the Act spells out the resultant liability on the issuer and the directors of the issuer where the section 37 requirements are not met. In brief, the issuer and the directors are jointly and severally liable for repayment of subscriptions.

Section 37's three minimum requirements are:

- no allotment of a security offered to the public is to be made unless there is a registered prospectus relating to that security(section 37(1));
- the minimum amount that the directors believe is needed to be raised for the scheme is raised within four months of the date of the registered prospectus (section 37(2)); and
- where a participatory security is offered the statutory supervisor has received a written statement authorising the subscription for that particular security (section 37(3)).

Failure to meet these minimum requirements results in the allotment of securities being invalid and of no effect (section 37(4)), without a subscriber being required to take any steps to avoid the allotment.[140] Section 37(5) also requires that the moneys be held in trust pending allotment of securities or return of money to investors. If the allotment cannot proceed due to the offering not meeting any of the three requirements then the consequences of failing to repay the subscription moneys falls on the issuer and the directors under section 37(6).

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138 See also *Abbott v UDC Finance Ltd* [1992] 1 NZLR 405, (1991) 5 NZCLC 67,362 (CA), 67,373.

139 Section 59(1). An example of a prosecution under this provision is *Registrar of Companies v Tonge* [1989] DCR 385.

140 *Cowles v Syndicated Investigations Limited* (1998) 8 NZCLC 261,581, 261,587

In *Re AIC Merchant Finance Ltd; National Mutual Life Nominees Ltd v Watson*, Richardson J pointed out that the obligation to meet the requirements of section 37 are placed "simply and squarely" on issuers.[141] In the same case, Doogue J remarked that:

> The obligation is on the issuer. It is for the protection of the subscriber … neither section 37 by itself nor the Act as a whole clearly excludes the rights that subscribers for allotments otherwise have as a result of the failure of the issuer to comply with either sections 37(1) or (5) … The policy of the Securities Act 1978 is not in my view to put strict limits on the rights of subscribers but to put stricter limits on those issuing such securities. The position of subscribers is sought to be improved, not limited …[142]

Section 37(1) provides that no *allotment* of a security offered to the public for *subscription* shall be made in the absence of a registered prospectus. If a prospectus is not in place at the time of the subscription then section 37(4) will render the allotment void.[143]

In *Paape v Fahey* (2005) 9 NZCLC 263, 813 (High Court), the minimum subscription amount under the prospectus was not subscribed and paid for four months from the date of registration of the prospectus. The investors successfully sued four of the directors under section 37 (6) of the Act.

4.9.2 The Relevant Public Offer

The first issue in relation to section 37 is that the allotment to be avoided has to follow on from an offer to the public. If the allotment is not related to the public offer then section 37 will not come into play. This issue was considered in *Dodge v Snow*[144] where Get Met Titles Limited (GMT) was looking for an active investor who would provide cash and management or other skills to the company. The company had issued 1,000 shares on 25 June 1997 amongst three shareholders (Crooks, Lilley and a trust). Snow held 600 shares as a "trustee".[145] One of the

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141 [1990] 2 NZLR 385, 392

142 Id, 400-401

143 *Re AIC Merchant Finance Ltd (in rec); Watson v National Mutual Life Nominees Ltd (No2)* (1988) 4 NZCLC 64,403; *Burberry Mortgage Finance & Savings Ltd (in rec) v Lewis* (M267/89, HC Christchurch, Tipping J, November 1, 1990); *Cowles v Syndicated Investigations Limited* (1998) 8 NZCLC 261,581, 261,585; *Dines Construction Ltd v Perry Dines Corp Ltd* (1989) 4 NZCLC 65,298

144 (1999) 8 NZCLC 261, 803. For a further discussion of this decision see P Fitzsimons, "SMEs, Raising Equity Capital, and the Securities Act 1978" [1999] *Company and Securities Law Bulletin* 37-43 (Part I), 67-71 (Part II)

145 *Dodge v Snow* (1999) 8 NZCLC 261, 803, 261 804

shareholders (Crooks) placed an advertisement in a business publication for a person interested in investing money and expertise into the company shortly after the company's incorporation. The advertisement stated:

> Investment and employment opportunity
>
> We are seeking an investor, with the management skills in sales and marketing to buy into a growing company already well established in New Zealand and with immense potential growth in Australia.
>
> Write to Investment Opportunity, P O Box 25-269, Christchurch or phone (021) 393-744. [146]

Mr Dodge neither saw that advertisement nor become involved with the company as a result of the advertisement. Instead, he came into contact with Snow because Snow's wife and Dodge's family attended the same church and their children played together. Snow suggested that Dodge become involved in "Get Met Titles Limited". Dodge began working in the business from mid-December 1997 and at the same time agreed to purchase an 8 percent shareholding in GMT for $60,000. The money was paid in instalments between late-December and late-January. He subsequently agreed to purchase a further 16 percent interest for $80,000 in the company. Eight percent came from Snow and 4 percent from each of the other 2 shareholders Crooks and Lilley. The second transfer of shares was settled on 6 March 1998.

GMT experienced financial difficulties so that Dodge was not even paid his wages. Dodge filed a summary judgment application in September 1998 in an attempt to recover his funds. Dodge's claim was based upon the fact that there was no prospectus registered by the company during its short life. Snow argued that there had not been an offer to the public under section 3 and that there was no causal connection between the advertisement and the allotment. In addition, as the shares were previously allotted Snow argued he could rely upon section 6(1).[147]

Master Venning first examined whether or not there was an offer of securities to the public. Dodge argued that the advertisement was an offer to the public in accordance with section

146 As the company had just been incorporated when the advertisement was placed the advertisement would appear to be misleading as it is difficult to see how the company could be said to be growing or be a well established business at that moment in time.

147 As these were the sale of previously allotted shares, Dodge sued Snow not as a director of Get Met Titles Limited, but rather as the issuer which is defined under section 2(1) as the person on whose behalf any money paid in consideration of the allotment of the security is received (section 2(l)(a)).

3(1)(c), in reliance upon *Orr v Martin*,[148] on the basis that section 3(1)(c) included a "teaser" (ie something less than an invitation treat but which is likely to or intended to stimulate an enquiry about an investment so as to give rise to an opportunity to meet a likely investment).[149] Master Venning accepted that this advertisement came within section 3(1)(c) on the basis that:

> In real terms it was an invitation to the public to come forward and take up shares in the company. The use of the phrases, "investment opportunity" and "to buy into" make that clear enough. [150]

Master Venning considered who had made the offer. Evidence was given that Mr Crooks, one of the other directors, had placed the advertisement but in his view Snow had "clearly authorised the advertisement, or went along with it" on the basis of his own evidence that he had adopted the advertisement and accepted it was placed with his approval.[151]

Master Venning then considered the relevance of that advertisement to Dodge's claim. What was the relevant offer that was made to the public? The offer via the advertisement of 7 June was not the offer which led to the allotment of shares to Dodge as he did not respond to it nor was he aware of it.[152]

Master Venning stated:

> The Plaintiff was not allotted shares in December following the offer in the June advertisement.
>
> Where, as here, the Plaintiff did not act in reliance upon the advertisement and the detailed terms offered to the Plaintiff were considerably different to those offered pursuant to the earlier advertisement, then from the Plaintiff's point of view is arguable the effect of the earlier offer was spent. Whilst the company and/or its directors may in the circumstances be in breach of s 33(1) by reason of the earlier offer and thus be liable for criminal proceedings it does not follow that a person in the Plaintiff's position can rely upon the earlier offer to pursue civil relief under section 37(6) for repayment of the subscriptions. The concluding paragraph of section 3(1) does not affect that position. As noted by Anderson J in Orr v Martin ... the question is what is the relevant offer?
>
> For liability under s 37(6) the subscription must follow and be related to the offer. For present purposes I find it at least arguable that the offer shares to the Plaintiff,

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148 *Orr v Martin* (1991) 5 NZCLC 67, 303
149 *Dodge v Snow* (1999) 8 NZCLC 261, 803, 261,806
150 Id, 261,807.
151 Ibid.
152 Ibid.

> which led to his subscription of shares, was not the same offer as that contained in any newspaper advertisements. [153]

The Court of Appeal upheld Master Venning's decision and agreed with his analysis of section 37. Blanchard J commented:

> We think that s 37(1) does not prevent an allotment (or a transfer caught by s 6(2)) unless there is a connection between the unlawful offering of the security to the public for subscription and the subscription actually made and pursuant to which the allotment occurs. The nexus may be quite weak. There may have been supervening events and changes to the terms of the offer. For example, if Mr Dodge had been put in contact with Get Met and Mr Snow because of a recommendation of Mr Green, s 37(1) might then have stood in the way of an allotment to him, even on terms quite different from those offered to Mr Green. The advertisement might be seen as an operating factor leading to the acquisition of shares by Mr Dodge. But in circumstances where the allottee knows nothing of the unlawful offer, and it has played no part in attracting the allottee towards the issuer, we consider that there is no breach of s 37(1) in the making of an allotment and that accordingly s 37(6) cannot operate – unless of course the offer to the allottee is by itself in breach of the Act because it is an offer to that person as a member of the public. [154]

The advertisement was clearly a public offer but not one Dodge could rely on. This decision makes it clear that the securities allotted have to be directly related to the public offer made. The mere fact that a public offer has been made is not sufficient to result in an allotment of shares void on its own. An investor attempting to rely upon section 37 would need to establish a clear nexus between the two in order to succeed in avoiding the allotment and recovering under section 37(6).

The need to link the offer and the allotment also provides an offeror with the opportunity to "bury" a past offering, which has not complied with the Act by ensuring that the persons and terms offered subsequently are different to the original offer. This opens up the possibility for an offeror to limit liability under the Securities Act by making separate offers. It may be possible to constitute each approach or allotment as a separate offer so that if one offeror is found to be a member of the public, the balance of the offers are not void under section 37. [155] Thus, *Dodge v Snow* indicates that an offer could be a different or a separate offering on the basis of timing of the offer, the terms of the actual offer (including pricing) and any other surrounding terms (for example, employment or commission on sales). For a company, internal documentation such as

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153 Ibid.
154 *Dodge v Snow* (Unreported CA21/99, February 22, 2000), 5.

minutes of meetings and directors' resolutions no doubt would also play a part in determining if there was one offer or a series of different offers.

4.9.3 Allotment and Subscription

The meaning of the terms "subscription" and "allotment" are important for determining what will be rendered void under section 37(4) and when potential liabilities for issuers and directors may arise under section 37.

Fisher J in *DFC v Abel* held that where there is a breach of section 37(1) it is the "allotment" that is avoided under section 37(4), not the security or the subscription.[156] It is necessary to identify the allotment before one determines what it is that has been avoided under section 37(4).[157]

In *DFC v Abel*, Fisher J noted that section 2(1) defined the term "allot" to mean "sell, issue, assign, and convey",[158] and that the Court of Appeal had commented in *Re AIC Merchant Finance Ltd* that "in contract terms allotment by the company was acceptance of the offer by the particular investor to place the funds on deposit with the company pursuant to the prospectus and on that security".[159] He held that the words "issue, assign and convey" meant that in exceptional circumstances allotments could also take the forms of dispositions of rights or interests.

Fisher J also considered the term "subscribe". Under section 2 this is defined as "purchase and contribute to, whether by way of cash or otherwise". He held:

> In the present context, that would seem to require some act signifying a willingness to make a commitment to the acquisition of a security. It seems that the act of subscription would normally take the form of an offer by the subscriber to purchase the interest offered by the issuer, which is capable of acceptance ("allotment") by the issuer. That would be consistent with the reference to "purchase" in the statutory definition and the discussion of "allotment" earlier. However, the definition of "subscription" is clearly broader than that. Thus subscription by "contribution"

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155 P Fitzsimons, "Play it [again], Sam": Offers to the Public in the New Zealand context" [1995] C & SLB 63, 71.
156 [1991] 2 NZLR 619.
157 Id, 625.
158 Ibid.
159 Ibid.

> seems to indicate the provision of valuable consideration in return for a security without the necessity for any underlying contract. [160]

Fisher J concluded that:

> From that brief survey I take it that the "allotment" to be avoided under s37 (4) will normally be the contract formed by the issuer's acceptance of a subscriber's offer to provide valuable consideration in return for an interest in present or future property, which property had initially been the subject of an invitation to treat communicated to the public by the issuer. No doubt there will be variations in unusual cases. For example, it would seem possible for the issuer to express the offer to the public in the form of a contractual offer capable of immediate contractual acceptance by the act of subscription itself. It would seem possible in principle to have a subscription and corresponding allotment by exchanging dispositions of property without any underlying contractual relationships at all. It may also be possible to have an offer to the public by one person and then an allotment emanating from an entirely independent person. However, I think that in the normal case, the "allotment", and hence the primary transaction rendered invalid and of no effect under s37 (4), will be a contract of subscription with the characteristics that I have described.[161]

On this basis it is necessary to identify the relevant contract between the issuer and the subscriber in order to determine what is comprised within the "allotment" to be avoided.

The meaning of the term "subscribed" in section 37(2) of the 78 Act has now been conclusively determined by the Judicial Committee of the Privy Council in *Christchurch Pavilion Partnership No 1 v Deloitte & Touche Tohmatsu Trustee Co Ltd* [2002] 3 NZLR 289; [2002] UKPC 4. In that case, Lord Scott of Foscote noted two possible meanings of the term "subscribed" as being actually paid or contractually committed and decided that the correct meaning for the purposes of section 37 (2) of the 78 Act was "actually paid".

4.9.4 Third Party Contracts and Section 37

Section 37(4) sets out the consequences of a breach of section 37: "Any allotment made in contravention of the provisions of this section shall be invalid and of no effect". The cases that have dealt with this provision deal with two scenarios. The first is where the subscribers are not seeking the recovery of funds (because the issuer is insolvent) but are rather seeking to avoid ancillary contracts, particularly loan obligations. The second is where subscribers attempt to recover funds when the issuer subsequently becomes insolvent.

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160 Ibid, 626.
161 Ibid.

Void Allotments and Ancillary Contracts

The first scenario commonly involves subscribers borrowing funds to invest in the scheme and subsequently finding that the scheme has failed and the issuer and directors are not worth pursuing. In such a case section 37(6), which requires the issuer and its directors to repay the funds with interest, is of little use as the subscriber is still left with a liability to the lender. The issue becomes whether the subscribers can use section 37 to avoid the loan agreement.

There are two main strategies for subscribers seeking to avoid continuing financial obligations for a security. The first is to argue that the loan formed part of the security and was therefore void under section 37. The second (discussed below) is to argue that the loan or other contractual arrangement was so closely associated with the security that it should also be struck down.

In *DFC v Abel,* Fisher J considered both of these arguments.[162] He held that a loan to an investor which is used to acquire securities is not a security itself, but merely a credit contract with the interests of the borrower protected by the Credit Contracts Act 1981.[163] Fisher J held that the mere expectation that a loan would be forthcoming in the future was not sufficient to create an existing security, nor did the fact that the promoter had provided an introduction to the financier. In his view the loan was not a security that could be avoided when examined from the point of view of the investor,[164] but rather:

> …vis-à-vis [DFC] they were purely borrowers. Consequently there was no allotment of "securities" by or on behalf of [DFC]. It follows there was no "allotment" to be avoided so far as [DFC] was concerned.[165]

On the second issue Fisher J stated:

> …the avoidance of that primary contract [i.e., security] will have far-reaching consequences for all other rights, liabilities and dispositions whose validity may happen to turn upon the existence of the primary contract. These will include, no doubt, collateral contracts between the same parties such as loans from the issuer to finance the subscriptions if the collateral contracts were clearly intended to be interdependent with the contracts for subscription themselves. However, I think, strictly speaking, contracts in the latter category will be void not because they were

162 *DFC v Abel* [1991] 2 NZLR 619
163 Id, 629.
164 Ibid.
165 Ibid.

> themselves allotments but because their validity has been dependent upon the validity of the allotments.[166]

Fisher J had previously considered the position of power of attorneys in *National Australia Finance Ltd v Fahey*.[167] He commented that:

> …there was certainly valuable consideration flowing from the plaintiff to the defendant and there is no suggestion that there was anything other than good faith on the part of the plaintiff. Both agency principles and the Property Law Act therefore suggest that the defendants are bound by the act of their attorney. By their own voluntary acts these defendants chose to place Mr Curtin in the position where he could effectively convey to third parties apparent authority to incur contractual obligations on their behalf. Their argument must be with Mr Curtin, not with the third parties who dealt with him in good faith.[168]

He was also of the view that there was no requirement for a third party to delve into domestic arrangements of a group where it has appointed a representative having its apparent authority.[169] He confirmed this view in *DFC v Abel* where the defendants again attempted to run an argument impugning the validity of the power of attorney so as to render the loan agreement itself void.[170] On that basis a third party can rely upon a power of attorney notwithstanding a breach of the Act provided that the apparent authority of the attorney cannot be challenged, which is likely to be the case where the other party is providing finance on an arm's length basis.

Fisher J then dealt with the next argument that the loans were an integral and essential part of a scheme, which breached section 37(1). He accepted that the invalidity of loans in that situation could in principle flow from either a contractual dependence upon the validity of the allotment itself or from illegality based on implied statutory intention. He accepted the defendants' contention that the loan formed an integral part of the scheme formulated by Curtin Farms Ltd and he also accepted that if the loan had come from Curtin Farms Ltd the loan contract would have been invalid as well as the allotment of securities. This would flow from the illegality based on implied statutory intention and possibly also from an implied term in the loan contract.[171]

Fisher J held in this case that it was not implied into the loan contract that the defendants' obligations would be dependent upon the validity of the contract of allotment between the

166 Id, 626.
167 *National Australia Finance Ltd v Fahey* [1990] 2 NZLR 482
168 Ibid, 484
169 Ibid
170 *DFC v Abel* [1991] 2 NZLR 619, 628.

defendants and CF Ltd. He then considered the issue of statutory intention. While he found that any contract forming part of the allotment itself would be void under section 37(1) as a result of section 37(4) he did not think that the legislature intended to go beyond that to strike down the loans of lenders to the subscribers where the lenders had not been a knowing party to the illegality. He puts forward a number of reasons for this. The first was that the Act expressly provides an elaborate range of consequences for the breach of section 37 (such as criminal and civil sanctions imposed under section 56 to 62 and the statutory avoidance of an allotment under section 37(4)).[172] The second was that the object of the Act is to protect investors not borrowers. On this point he commented:

> There are special reasons for invalidating loans to investors where the loans emanate from promoters. In those circumstances the investment and the loan may or may not be recorded on different pieces of paper but they involve essentially one transaction between the same parties. The substance of the transaction is still the investment of the investor's own funds. The loan is simply a detail of the form in which the investment terms are agreed between the promoter and the investor. The position is different where a member of the public enters into an investment contract with a promoter and to finance this simultaneously enters into a loan contract with an independent financier. In his relationship with the financier the individual is purely a borrower…Nor do I think that this analysis is affected by the fact that the promoter might have arranged the loan facility with the financier before the offer to the public so long as the financier was not a party to any offer and allotment to the public without a registered prospectus.[173]

The third reason for not holding that the Act avoided the loan documentation was that the proscription under section 37 "should not be extended to innocent third parties without compelling reasons", and that the Act provided civil and criminal liability for those who had personal responsibility.[174] He also was of view that the financier was not a promoter since it was not "instrumental in the formulation of a plan" pursuant to which securities were offered to the public as required by section 2.[175] It had been accepted for the purposes of argument by the investors that DFC was not directly or in directly a party to, or implicated in, the offer to the public without a registered prospectus.

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171 Id, 630.
172 Id, 631.
173 Ibid.
174 Ibid.
175 Id, 632.

Fisher J distinguished the facts of the case from the Australian case of *Hurst v Vestcorp Ltd*.[176] In that case the offeror of the investment scheme was also the lender, and the relevant legislation did not contain the equivalent of section 37(4), and as a result the allotment and the loan were both avoided.

A critical issue, therefore, in determining the validity of an ancillary contract is the degree of connection or interdependence between the allotment and the ancillary contract, and the role, or association with the offeror, of the other party to the ancillary contract. How closely involved does a third party have to be before its contract is also avoided? In *DFC v Abel* it had been accepted for the purposes of the hearing that DFC was not involved in promoting the scheme so that Fisher J did not need to consider whether or not DFC was a promoter of the offering.[177] This concession was not made, however, in *DFC Financial Services Ltd (in stat mgt) v Schulze* where summary judgment was sought by DFC against members of another bloodstock partnership.[178] The investor argued that DFC was a promoter as defined section 2(1) of the Act by virtue of the terms of the loan offer (which required a warrant from each borrower that he or she had become a member of the partnership pursuant to “a certain Private Offering Memorandum”), the close ties DFC was purported to have had with the promotion, issuing and purported allotment of the securities, and that DFC knew of the breach of section 37.[179] The investors wished to gain access to DFC’s documents to be able to determine its true involvement in the offering. Master Towle held that this was sufficient to raise an arguable defence given that Fisher J had based his decision in *DFC v Abel* on the ground that DFC was an innocent third party financier. While the Master was referred to *DFC v Abel* and *National Australia Finance Ltd v Fahey*, he was not referred to the Court of Appeal decision in *Abbott v UDC Finance Ltd*[180] which had been decided in the previous year.

In *Abbott v UDC Finance Ltd* the investors also argued before the Court of Appeal that UDC was not “a complete stranger to the invalid scheme”. They based their claim on a number of factors. First, UDC had prepared the loan application form and, second, the “placement memorandum” stated that the formation of the partnership was conditional upon lender’s approval of the partners; it contained the proposed terms of the loan, and contained a statement

176 (1988) 12 NSWLR 394.
177 *DFC v Abel* [1991] 2 NZLR 619, 632
178 (CP81/91, HC Hamilton, Master Towle, February 14, 1992)
179 Id, 10
180 [1992] 1 NZLR 405

that a condition of participation in the syndicate was execution of the power of attorney. [181] The Court of Appeal rejected the first argument on the basis that:

> So far as UDC were concerned, they were asked to advance money to a partnership of investors in broodmares and stallion shares. There would be nothing unusual in a finance company, having been asked to advance money to such a partnership, providing a form of loan application setting out the information which it would require for its assessment of the proposal. There is nothing in that fact to suggest that the respondent was involved in setting up of the investment, or was aware of any facts that might suggest a possible breach of the Securities Act.[182]

The Court of Appeal also dismissed the second argument on the basis that these facts did not suggest any involvement of UDC other than as lender or any knowledge on UDC's part of a breach of the Act. The Court of Appeal was also very unsympathetic to an argument that lenders had an obligation to ensure that the Act was complied with by the offeror.[183] Overall, the Court commented that:

> There is nothing to suggest that UDC was involved in the promotion of the scheme or in the breach of the Securities Act. It was in the category of the "innocent third parties" referred to by Kirby P in…*Hurst v Vestcorp Ltd*. The loan agreement to which it was a party can and should be severed from the arrangements entered into between Curtin Farms Ltd and the appellants, and it is not to be affected by illegality of the allotment of interests.[184]

The Court of Appeal and the High Court's approach is understandable as the court clearly feels that it is the investors, not the financiers, who should bear the risk of the success or failure of the scheme. A financier's role is to assess the credit risk of the borrower rather than to protect investors from poor investment decisions. Accordingly, it is not surprising that the courts are relatively unsympathetic to attempts to taint a loan with illegality so as to shift the loss onto the financiers.

This decision puts paid to the argument in *DFC v Schulze* that provision of loan documentation and even references to the loan in the offer documentation is sufficient to taint the loan. If the lender merely acts as a financier then, absent a relationship with the offeror (such as being an associated company), the loan agreement will not be declared invalid. However, *Abbott v UDC Finance Ltd* does not leave third party financiers entirely in the clear. If a borrower can show

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181 *Abbott v UDC Finance Ltd* [1992] 1 NZLR 405, 414-415. See also *National Australia Finance Ltd v Fahey* (1991) 5 NZCLC 66,827.

182 *Abbott v UDC Finance Ltd* [1992] 1 NZLR 405

183 Id, 415

that the lender did in fact have a greater involvement in the offering then this may be sufficient to attack the validity of the loan. For example, if a financier actively seeks out promoters and offers them packages for their schemes, has a close working relationship with the promoter over a number of offerings, or actively promotes the scheme with its own client base then this may be take the financier across the line from independence to an association that taints the loan and may even make them a promoter. The second point is that these decisions all arose from tax-driven bloodstock in the 1980's at a time when the provisions of the Act were relatively untested and unknown. Given the length of time that the Act has been in operation and the number of cases on the validity of offerings and loans it may be more difficult for a lender to argue that it was not aware there was a breach of the Act in some instances. While the lender does not have an obligation to ensure that the Act is complied with,[185] if it has notice of the likelihood of a breach (for example, where an offering of securities is made to a large number of investors without a registered prospectus in place) it may be possible to argue that the financier should have known of the illegality and therefore should wear the loss associated with the loan.

The courts have taken a similar approach to investors' attempts to avoid guarantees provided to guarantees provided to third party financiers. In *Hyslop v The Society of Lloyds,*[186] Mrs Hyslop signed up as a Lloyd's name, and when called upon to pay for the liabilities that had accrued through a number of disastrous years for the insurance industry, she applied for the cancellation of various agreements she had made with Lloyd's, as well as the cancellation of counter indemnities provided to financial institutions. The case was essentially about whether or not the English courts had jurisdiction over the transaction but in examining the Securities Act issues Richardson J commented that:

> The ground of challenge is that those agreements…are all part of a series of interrelated contracts which are all tainted by breach of the Securities Act. I am satisfied that the agreements are interrelated, that they are to be construed together and that there is a good arguable case that any invalidity of the initiating agreements with Lloyd's and Oxford may affect the enforceability of agreements down the chain, and in particular the deed of counter indemnity and related securities.[187]

McKay J, however, was not as sure of the impact of an allotment of securities being void under section 37 as he commented that even if a security had been offered to Mrs Hyslop it did not

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184 Ibid
185 Ibid
186 [1993] 3 NZLR 135
187 Id, 138

"follow that the Court should interfere with the enforcement of the guarantee",[188] These were obiter comments as the court found that there had been no offer of securities to the public.

In *Barclays New Zealand Ltd v Davison*[189] Hansen J faced this issue directly. Davison had signed up as a Lloyd's Name and subsequently tried to avoid liability under a counter indemnity to Barclays, which had in turn guaranteed certain liabilities for the Names Syndicate. Hansen J followed the Court of Appeal's decision in *Abbott v UDC Finance Ltd* and Fisher J's decision in *DFC v Abel*.

Although Hansen J's judgment came out just before *Hyslop* and Richardson J appeared to favour invalidity of the counter indemnity, there would appear to be no reason to treat a guarantee to a financial institution any differently to a loan to an investor. The mere fact that they are interrelated (as Richardson J found) does not advance the position. In *Abbott v UDC* there was an interrelationship between the loan and the securities offered but the Court of Appeal there clearly required more than that before the ancillary contract would be struck down and approved Fisher J's approach in *DFC v Abel* which required that the contracts were intended to be interdependent not merely related to each other.

While these decisions have focused on third party financiers there are other decisions that focus on contracts with the issuer or other investors. *Tilley v Anderson*[190] involved another bloodstock syndicate promoted by Curtin Farms Ltd and was as equally unsuccessful as the syndicates in *National Bank Finance Ltd v Fahey and DFC v Abel*. In this case the majority of investors settled their outstanding liabilities for the syndicate's loan from UDC and then sought, by way of a summary judgment, contribution from two members who were not part of the settlement. Anderson claimed that in signing his power of attorney he had expressly limited it to an overdraft limit of $20,000 by virtue of a letter he had sent to Curtin Farms Limited. As Master Williams made clear, any limitation upon the use of a power of attorney is ineffectual against third parties not aware of the limitations.[191] However, he also held that the attorney has an obligation not to act contrary to the interests of the attorney's principal and unfortunately for those investors who had settled with UDC this meant they were imputed with knowledge of the

188 Id, 153.
189 [1993] MCLR 241.
190 CP442/92, HC Wellington, Master Williams QC, August 26, 1992
191 Id, 8

limitation placed upon the power of attorney.[192] The effect of this was that the partners who settled with UDC were not allowed to recover a contribution from Anderson. It appears that they had made a mistake in that they had sought contribution from Anderson as a partner rather than using the rights of action against Anderson that had been assigned to them by UDC under the settlement.[193] If they had proceeded under that cause of action it appears they would have been successful, as Anderson could not dispute the loan contract with UDC.

International Standardbred Partnership v Garland[194] involved a bloodstock partnership pursuing a partner for outstanding partnership fees rather than a third party financier seeking to recover a loan. The securities offered were void as no prospectus was registered and Garland objected to paying the contribution being demanded by the other partners. Master Williams commented that:

> The plaintiff partnership sought to avoid such a finding by reference to a number of the other cases relating to the collapse of bloodstock syndicates which have been determined by this Court and the Court of Appeal in recent years…the difference between all those cases and this is that they were all claims by the financiers of the bloodstock syndicate not, as this case is, by the partnership itself for unpaid partnership contributions.[195]

After citing Fisher J's comment in *DFC v Abel* that any contract forming part of an allotment was void under section 37 Master Williams stated:

> This claim is by the plaintiff partnership for unpaid contributions which could only be payable by the defendant if the partnership agreement, pursuant to the contract forming part of the allotment, is valid. The plaintiff has failed to satisfy the Court that the partnership agreement is not arguably void and it follows that…the application for summary judgment requires (sic) to be dismissed.[196]

In two Australian cases after *Hurst v Vestcorp* the courts arrived at similar results. In *Australian Breeders Co-op Society v Jones*[197] the Full Federal Court dealt with another bloodstock syndicate where the financier purchased the mares, leased them to investors and lent those investors funds for their investment. The Court held there that the result of the illegal offer made to investors was to render void the management agreement between the promoter and the

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192 Id, 9-10
193 Id, 6-7
194 (1992) 6 NZCLC 67,812.
195 Id, 67,823
196 Ibid
197 (1997) 26 ACSR 26

investors but also the investors' interests in the bloodstock, the agreements for loans and the mortgages securing those loans. It commented:

> The "heart of the transaction" was the documents tainted with illegality: the lease agreements and management agreements. The loan and mortgage agreements were merely ancillary. Even so, the elimination of the management agreements would not leave them unchanged. As counsel for the investors point out (sic), the management agreement controlled the rights and obligations of the parties to the lease agreements. The invalidation of the management agreements necessarily results in a variation of the operation of the lease agreements. The invalidation or variation of the lease agreements affects the loan and mortgage agreements.[198]

The end result of the invalidation of the management agreements and the change in the operation of the lease agreements was that the loan and mortgage agreements were also rendered invalid.[199]

Amadio Pty Ltd v Henderson[200] involved an attempt to gain capital and tax advantages out of the sale and purchase of a building rather than bloodstock. A company purchased a building and on-sold it investors with vendor finance provided. Unfortunately the property crash hit Melbourne severely in the early 1990's with the effect that the building value declined from a reputed value of $14 million to $8 million in a short space of time and the rental income took a similar fall. The vendor sought to recover the whole of the loan and the investors in turn sought to avoid their obligations. The Full Federal Court upheld Heerey J's decision in the lower court that:

> The finance from the vendor was an integral part of the investment package. It enabled entry with a relatively small initial payment compared to the total value of the property and was essential for the taxation advantages. It was a special condition of the contract of the sale (condition 2) that the vendor should advance to the purchasers the sum of $16.265 million to be secured upon a mortgage in the form of a draft annexed to the contract. In reality, the 'offer' or, in legal terms, the invitation to treat was to subscribe $40,500 and to enter into the mortgage back to the vendor. It was the same entity, Amadio, which was the vendor and the lender. No third party was involved.
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> In marketing of the scheme, especially as presented in the cashflow, the finance offered was an integral part of the scheme, not a facility available to investors, which they might or might take up. There was never the slightest suggestion that anyone

198 Id, 77-78
199 Id, 78
200 (1998) 81 FCR 149

> could or would buy without borrowing from Amadio, or borrow from Amadio without buying.[201]

This decision highlights the difference between the promoter and a third party providing finance. If an independent financier had provided the finance it is likely that the investors would not have been able to avoid the loan.[202] They would still have had a claim against the offeror and promoters but would have had to rely upon their solvency in order to be able to recover any funds.

In summary, the following appears to be the approach of the courts to the issue of associated or collateral contracts where the allotment has been held to be void:

- Is the collateral contract an allotment of securities itself?

  Loan documentation and powers of attorney, on their own, are not allotments (*DFC v Abel, National Bank Finance Ltd v Fahey*). Contracts created in the scheme, in addition to the contract for the securities, such as management agreements and lease agreements are part of the allotment to be avoided (*DFC v Abel*, *Australian Breeders Co-op*);

  If partners attempt to recover funds from fellow partners they will usually be unsuccessful if their claims relies upon the contribution as a partner since the partnership itself will be rendered void under section 37(4) (*Garland, Tilley*).

- Is the collateral contract dependent upon the validity of the allotment?

  If the promoter or issuer is the provider of the funds then the courts tend to treat the loan as either dependent upon the validity of the allotment, or as part of the same transaction and void under section 37 (*DFC v Abel, Hurst*, *Amadio*, *Australian Breeders Co-op*);

  Loans from, or guarantees to, innocent third party financiers are not considered to be dependent upon the validity of the allotment (*DFC v Abel, Abbott v UDC*, *National Bank Finance Ltd v Fahey, Davison, Lloyds*). This would change if the financier were involved in the promotion of the scheme so as to become a promoter (*DFC v Schulze*),

201 Id, 192

202 As it was the Court held that the investors were liable in restitution for some of the cost of the building as they ended up as its owners, but the promoters had to suffer the loss in value of the building.

Trust deeds and security documents for debt securities would be avoided as they depend upon the validity of the underlying allotment (*Re AIC, Re Dingwall & Paulger (in rec), Re Loan and Finance (Dunedin) Limited (in rec)*).

Validating a Void Allotment

While the first scenario involves investors attempting to avoid ancillary contracts, this second scenario involves innocent subscribers who have paid for their securities only to find that due to non-compliance with section 37(1) their securities are void and that they are left to compete with other unsecured creditors for a share of the residual assets of the issuer. In such cases the subscribers have relied upon the Illegal Contracts Act 1970 in an attempt to have their securities validated.[203]

The first case to deal with that issue was *Re AIC*.[204] AIC Finance Ltd had executed a debenture trust deed in favour of National Mutual to enable AIC to offer securities to the public. Two prospectuses were registered but due to administrative errors there was a 22 day gap during which subscriptions were received. National Mutual appointed receivers to AIC who applied to the High Court. Amongst other matters, they sought directions on whether certain investments received in the time lag between the issue of two of AIC's prospectuses were valid. The subscription money had not been held in trust as required by section 37(5).[205] In addition, the right of action against directors under section 37(6) was of little value as the directors were facing large claims, which they were unlikely to be able to meet. The minority, Richardson J held that, although validation of the allotment was not available, other forms of relief were available under section 7 Illegal Contracts Act 1970 (NZ).[206] The majority, however, held that it could validate a void allotment despite section 4 of the Act.[207] Casey J commented that relief would not normally be available under the section 7 if relief was available under section 37(5)

203 It is also possible to argue that a constructive trust for the funds invested has been formed: see *Re Loan and Finance (Dunedin) Limited (in rec)* (1990) 5 NZCLC 66,367 and *Dines Construction Ltd v Perry Dines Ltd* (1989) 4 NZCLC 65, 298. It should also be noted that Anderson J in *Orr v Martin* ((1991) 5 NZCLC 67,383, 67,389) was of the view that once an issue of securities were void under the Act then it was open to the subscribers to argue that there was a total failure of consideration at common law or equity and to seek recovery on that basis. The value of that claim obviously depends upon the solvency of the issuer.

204 [1990] 2 NZLR 385

205 Id, 392

206 Id, 393

207 Id, 397 and 400.

and (6) as the investor would receive back their funds plus interest.[208] However, he commented that:

> …the relief intended by the Securities Act is not in fact available because of the issuer's failure to comply with subs (5) and its subsequent insolvency and because of the evident lack of effective recourse to the directors. In those circumstances I can see nothing between these Securities Act provisions and the alternative provided by s 7 of the Illegal Contracts Act. Indeed, the latter complement and fulfil the formers' manifest object of protecting the subscriber. Accordingly, I would find there is jurisdiction to validate the contract of allotment.[209]

Following *Re AIC,* the court in *Re Dingwall & Paulger (in rec); Re Steel v NZ Guardian Trust Co.* gave relief, on the basis of the facts of that case.[210] Ellis J in applying section 7 of the Illegal Contracts Act stated that:

> In this case the company was acting on advice and in good faith. Full disclosure of the terms of the deposit from time to time was made to the trustee and the depositors. At all times the company, the trustee and the depositors thought they were secured by second ranking stock.[211]

Despite the fact that validation of the allotment would reduce the payment to other unsecured creditors by 11 cents in the dollar Ellis J, after weighing up the relevant factors and considering the overall justice and fairness of the result, was of the view that "not to grant relief would be an unexpected windfall for other unsecured creditors, and virtually everything points towards granting relief".[212]

In *Westpac Financial Services Ltd v Securities Commission*[213] Doogue J, who was in the majority of the Court of Appeal in *Re AIC*, dealt with a situation where Westpac relied upon an exemption notice which allowed it to make an offer in New Zealand by using its Australian prospectus. Due to administrative oversight certain conditions in the exemption notice were not fulfilled and the allotments were void. Doogue J was prepared to validate the allotments since there was nothing in the conduct of the parties that required a refusal to grant relief, the breaches

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208 Id, 398
209 Ibid.
210 (1990) 5 NZCLC 66,780.
211 Id, 66,791.
212 Ibid.
213 (1996) 7 NZCLC 261,106.

were of a trivial kind, there were no interests affected other than Westpac and the relevant investors and the majority would be prejudiced by invalidity.[214]

By contrast, the court in *Re Loan and Finance (Dunedin) Limited (in rec)* refused to grant relief.[215] Here investors had "rolled over" their investment at a time when a registered prospectus was not available. Fraser J held that the new or amended certificates issued to investors amounted to "allotments".[216] He considered that relief would not undermine the Act but that, unlike *Re AIC*, the investors would receive some payment even if relief were granted. In addition, unsecured creditors would be adversely affected so that they would not receive any payout. Consequently, Fraser J refused to grant relief even though the investors were innocent parties after weighing up all the factors.[217]

4.9.5 Minimum Subscription Requirement

The second major requirement under section 37 relates to raising the minimum amount of subscription. Section 37(2) requires, where the issuer is offering securities to the public for the first time and where the directors express an opinion in the registered prospectus as to the minimum amount required for the activities of the issuer, for that minimum amount to be subscribed for and paid to the issuer within four months after the date of the registered prospectus. Where the subscription amount is paid by cheque the subscription is deemed to be paid if it is received in good faith and no reason to suspect the cheque will not be paid exists.[218] The minimum amount must be paid in cash as no other form of payment is to be taken into account.

Cartwright J in *Re The Pavilions, Christchurch Prospectus; Christchurch Pavilion Partnership No 1 v Deloitte Touche Tohmatsu Trustee Company Limited* commented on the purpose of this provision:

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214 Id, 261,112. He did make an order which enabled certain investors who withdrew their investment to receive a payment in terms of section 37(5).

215 (1990) 5 NZCLC 66,367.

216 Id, 66,374

217 Id, 66,377

218 In *Murray v Morel & Co Ltd* [2007] 3 NZLR 721, the Supreme Court of New Zealand held that a cheque delivered on the basis that it never be presented was a deemed payment under section 37 (2) (a) of the 78 Act.

> The four month time limit on payment of subscriptions imposed by s 37(2) is a further protection to investors to avoid a lengthy delay, which might render the information in the prospectus unreliable.[219]

This subsection imposes a significant time constraint upon an issuer and places the directors in a difficult position. On the one hand, if the minimum amount is set at a relatively high amount then it may be difficult for the issuer to reach that level within the four month time-frame – a failure to do so will mean that all the subscription moneys have to be repaid and leave the issuer (and perhaps the directors) liable for the cost of the unsuccessful offering. These costs can be significant when legal fees, audit fees, expert's fees and advertising and printing costs are taken into account. If a shortfall looks likely by the end of the four month period, the directors are placed under pressure to subscribe for the shortfall by themselves (which is permissible unless the prospectus indicates they will not subscribe). In *Re The Pavilions, Christchurch Prospectus*, for example, the promoter undertook to underwrite the offering and, in fact, nominally subscribed for an amount above the number to be underwritten and then sought to onsell its interests.[220] It needed to take this course of action because it had stated in the prospectus that the minimum amount needed was the full amount being offered.[221] Alternatively, the directors may try "play" with the subscriptions so as to make it appear that they have reached the minimum required (which was also the position in *Re The Pavilions, Christchurch Prospectus*).[222]

On the other hand, if the minimum amount is set too low from an objective viewpoint the project (if not fully subscribed) may founder. While the issuer may then be able to move to allot the securities and cover the costs out of the money subscribed, the project may suffer from a lack of capital, which places the success of the project in doubt. In *Re The Pavilions, Christchurch Prospectus*, for example, the failure to gain the appropriate level of subscriptions meant that capital was not available from investors to purchase land with the result that a standby loan had to be drawn upon with the associated interest costs (which increased the costs of the project and lowered returns to investors), that interest that could have been earned on the balance of the

219 (1998) 8 NZCLC 261,675, 261,693

220 The court found that the amount paid by the promoter for the underwritten securities was effective returned to the promoter in a swap of cheques with the result that the partnership did not in fact have the cash that should have been in its accounts – see (1998) 8 NZCLC 261,675, 261,700

221 (1998) 8 NZCLC 261,675, 261,685

222 Where the issuer is offering participatory securities or units in a unit trust an allotment cannot be made unless the statutory supervisor has received at the time of the allotment a written statement from a subscriber

subscriptions was not received, and management's energies were focused on financing the project rather than on the project itself.[223]

If the minimum amount is objectively too low to cover the issue costs and for the project to be undertaken, the directors may have personal liability as it may be argued that their opinion as to the minimum amount required for the issuer's activities is a misstatement attracting liability under sections 56 or 58 of the Act. [224] In addition, they may face criminal liability under section 250 of the Crimes Act 1961 which provides that a person who is a promoter, director, manager, or officer of any company either existing or intending to be formed makes or circulates any prospectus or statement which is "known to be false in any material particular" with intent to induce persons to become shareholders or member (section 250(a)) or to deceive or defraud members, shareholders or creditors of the company, whether ascertained or not (section 250(b)).[225] Alternatively they may incur civil liability for misleading or deceptive statements caught by section 9 of the Fair Trading Act 1986.[226]

The minimum subscription requirement was further considered by the Privy Council in the *Christchurch Pavilion Case.* Here, the promoter, Horner Greenlees Corporation Limited (HGC), sought to raise monies to build a luxury motor lodge complex in the South Island of New Zealand. HGC registered a prospectus to issue equity securities and participatory securities. Under the prospectus, the minimum amount to be raised was $4.5 million. In the event, $3.24 was raised and allotment occurred in respect of this amount. The project failed. Clearly, section 37(2) was violated. There was no point in suing the issuer as the issuer was insolvent. Instead, the statutory supervisor of the participatory securities was sued. The Privy Council held that the allotment breached section 37 (2) of the 78 Act and the statutory supervisor had breached its duty of "reasonable diligence" but that the latter breach of duty was not causative of the investors loss. It also held that the minimum amount required under section 37(2) is not

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authorising the subscription for that particular security. The safeguard provided by a statutory supervisor is not always foolproof – see *Re The Pavilions, Christchurch Prospectus* (1998) 8 NZCLC 261,675, 261,683.

223 *Re The Pavilions, Christchurch Prospectus* (1998) 8 NZCLC 261,675; 261,685.

224 See P Fitzsimons, "If the Truth Be Known: Directors' Liability for Misstatements in a Prospectus" (1999) 5 NZBLQ 164 (Part I).

225 Another relevant Crimes Act provision is section 229A which creates an offence for using a document to obtain a pecuniary advantage - see *R v Baxter* (CA57/98 15 May 1998) for an example of the application of this section to a public offering of shares.

226 P Fitzsimons, "If the Truth Be Known: Directors' Liability for Misstatements in a Prospectus" (2000 6 NZBLQ 1 (Part II)

subscribed unless it is actually paid. Because the $4.5 million had not been subscribed the allotment was invalid.

4.9.6 Resurrecting an Allotment

An important issue for offerors is where an error is made and allotments are made prior to the registration of a prospectus with the result that the allotments are void. This can happen, for example, where the offeror assumes that a prospectus has been registered and makes allotments when registration had not been effected for some reason or where an offer is made without a prospectus and the offeror seeks to remedy the situation by subsequently registering the prospectus. In both cases there may be a breach of section 59 but the question is whether the issuer can still effectively allot the securities under section 37.

In *Re AIC Merchant Finance Ltd (in rec); Watson v National Mutual Life Nominees Ltd (No2)*[227] Henry J dealt with a situation where a finance company regularly registered "roll-over" prospectuses. Due to technical problems with the next prospectus in the series it was not registered by the anticipated time. Nevertheless the finance company had taken subscriptions from investors and allotted securities. When the error was realised investors were given new application forms under the properly registered prospectus, which they filled in confirming their investment and returned to the offeror without their money being first given back to them. Henry J commented:

> The completion of the correct application forms resulted from a letter dated 21 July 1986 (i.e. after registration) sent to investors "a new application form for our records pursuant to the Securities Act 1978". I have no difficulty in holding that the return of the application form, with the necessary implied authority to use the funds earlier paid for that purpose, was a subscription in the terms of the legislation. The apparent breach of sec 37(5) by failing to place the funds in a trust account or to repay previously is irrelevant. There was at the relevant time a registered prospectus relating to the securities in question, and the allotment resulting is therefore valid. Allotment would have been effected on receipt by the company of the new application form and its processing.[228]

Henry J's decision was followed in *Cowles v Syndicated Investigations Limited*.[229] The decision forms part of the saga surrounding an attempt by a Mr Baxter to retrieve gold alleged to be in the "General Grant" which founded off the Auckland Islands in 1866. Baxter had been previously

227 (1988) 4 NZCLC 64,403
228 Id, 64, 409

prosecuted for misleading statements in a prospectus,[230] and in this case one of the investors in the scheme Baxter put up to raise funds for the venture attempted to obtain his money back.

Mr Cowles had seen a programme about the venture and wrote away for a prospectus. He invested $1,000 but was advised that the promoters had failed to raise the necessary monies and returned his funds to him. Cowles later received an undated three page letter headed "The 1995 General Grant Gold Bullion Recovery" in which he was advised that there was a possibility of funding a private expedition. Subsequently, Cowles decided to invest a further $2,000 in the venture. From April 1995 to 7 June 1995 he forwarded further cheques totaling $34,000. He had never met Baxter or any of the other parties associated with the company before the initial approach. Baxter then attempted to remedy the situation by registering a prospectus on 27 June 1995, copies of which were sent out to investors. Cowles completed the application form and returned it to Baxter's accountants on 30 June 1995. Master Venning stated:

> In those circumstances, in my view, it is sufficiently arguable for the purposes of this summary judgment application that by returning the application form the Plaintiff gave the First Defendant implied authority to use the funds earlier paid. It was a subscription in terms of the legislation, and the fact that s37 (5) was not complied with is irrelevant.[231]

Although the time difference between the receipt of the investor's money and the receipt of the subscription form was significant in this case when compared with the position in *Re AIC*, Master Venning was still prepared to consider the subscription application received sufficient to be compliance with section 37(1). On the basis of these two decisions the potential liability for a void allotment for want of a registered prospectus can be prevented if a prospectus is registered and a subsequent subscription notice is received based on that prospectus and the other provisions of the Act are complied with (for example, the provision of an investment statement under section 37A(1)). Even breach of section 37(5) by failing to return the subscription moneys as required by that provision is not an obstacle to finally satisfying section 37(1).

It remains to add that, as of 15 April 2004, a new statutory regime for relief orders in respect of section 37 has been established. This regime provides a means for an issuer to seek a mandatory

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229 (1998) 8 NZCLC 261,581

230 *R v Baxter* (CA) 57/98 15 May 1998 and see P Fitzsimons, "If the Truth be Known: The Securities Act 1978 and Directors' Liability for Misstatements in a Prospectus" (1999) 5 NZBLQ 164, 189 for a discussion of this decision.

231 *Cowles v Syndicated Investigations Limited* (1998) 8 NZCLC 261,581, 261,586

or discretionary relief order in respect of a failure to comply with section 37: see sections 37AA through 37AL of the 78 Act.

4.9.7 Dealing with the Funds Received

How are funds that are received from subscribers dealt with pending allotment or their return? The requisite funds must be kept in a trust account until allotment or until they are repaid: see section 36A. Where an issuer receives subscriptions and the securities are, for whatever reason, not allotted, they must be repaid, with any interest, to subscribers as soon as reasonably practicable: see section 37 (5) of the 78 Act.

In *AIC Merchant Finance Ltd* Richardson J commented that the legislative intent of section 37(5) "was to protect the subscribers by having their subscriptions segregated and held in trust for them".[232] Casey J remarked, however, that: "It is clear that the protection afforded by sub section (5) will assist the subscribers only if the issuer carries out its obligation to hold the subscriptions in a trust account."[233]

An important case on this provision is *Dines Construction Limited v Perry Dines Corporation Limited & Ors*.[234] There the defendant intended to raise capital through a share issue. The defendant set up a bank account into which the plaintiff paid part of the subscription moneys before the prospectus was issued. The plaintiff and defendant agreed that these moneys could be used for the defendant's general purposes. Ultimately, though, the share issue was not made.

Ellis J held that the money paid for the shares still constituted a subscription, which came under section 37(5) even though no prospectus had been issued:

> The question is whether something more is required than the payment of money alone. In my view the subsection is designed to ensure that all monies paid for securities were protected until allotment, and it is not framed in terms requiring formal compliance with the mandates of the prospectus. It may well be that DCL had not purchased the securities by simply making the payment, but in my view the payment was unequivocally made and received as a contribution for the shares. It may well be too that DCL could refuse to allot shares unless there had been formal compliance with the prospectus: *Re Pacaya Rubber and Produce Company Ltd*

232 [1990] 2 NZLR 385, 392
233 Ibid.
234 (1989) 4 NZCLC 65,298

> [1914] 1 Ch 542 at p 554. However, as I have said, the subsection is designed to protect contributions, not contracts.[235]

The defendant also submitted that the obligation to hold contributions in a trust account only arose when the securities were not allotted. Looking at the wording of the section, however, Ellis J rejected this. His Honour said "the remedial effect of the subsection is to protect subscriptions until allotment in all cases, not only those void or irregular under the Act".[236]

4.9.8 Liability for Repayment of the Funds

If the subscription moneys are not held in trust, section 37(6) is designed to provide a remedy for subscribers. It provides that if repayment is not made within two months (or five months in the case of a non-allotment due to a failure to reach the minimum subscription) then the issuer and all of the directors are jointly and severally liable to repay the subscriptions together with interest at the prescribed rate from the date the subscriptions were received. A defence to the liability imposed by this provision is provided to a director where the director proves that "the default in repayment … was not due to any misconduct or negligence on his part".

In *Alexander v De Lacy* the defendants were directors of two companies in which the plaintiff had invested which subsequently went into liquidation.[237] There was a discrepancy as to the amount of unpaid capital and the plaintiff brought a summary judgment application under section 37(6) against the directors in order to recover the money paid.

Master Hansen dismissed the application. He remarked that the proviso to section 37(6) made it clear that directors are not liable if they can establish that the default in the payment was not due to any misconduct or negligence on their part.[238] The Master agreed with the submission that:

> …negligence in terms of section 37(6) should be construed as meaning the absence of reasonable care and skill that a reasonable director would exercise in all the circumstances including the size of the company, its financial circumstances, the nature of the security offered and its purpose…It would be relevant to take into account the difference between a professionally advised director of a large public

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235 Id, 65,306
236 Id, 65,306
237 *Alexander v De Lacy* (1993) 6 NZCLC 68,020.
238 Id, 68,022

> company, compared with the director of a small private company with, perhaps, limited business skills.[239]

Master Hansen also took into account the fact that it was arguable that the defendants took legal advice. This point was also important in assessing whether the failure to make repayment was due to misconduct or negligence.[240]

In *Cowles v Syndicated Investigations Ltd,* Master Venning held that one of the defendant directors had an arguable defence under section 37(6).[241] He joined the company after the subscriber had forwarded money to the issuer, he understood that solicitors were attending to issues relating to the prospectus, and when concerns were raised he convened a meeting to discuss them. In addition, the subscriber did not demand his money be returned before the director resigned.

These two cases illustrate that the courts will be receptive to a defence based on the proviso to section 37(6) taking into account all the circumstances.[242] Obtaining legal advice or at least relying upon legal input appears to be a key aspect of the defence. It is doubtful if a person who took no part in the process of the offering or failure to return the subscription money could rely upon the defence since it is likely that the court would find them negligent at least.

An interesting issue was raised in *Agnew v Gould*.[243] Shareholders had sued one of the directors under section 37(6) but not the others. This director claimed that he had a right of contribution from the other directors. The other directors argued that the Act did not create a right of action between directors for contribution under section 37. Master Venning referred to Australian authority that held that the doctrine of contribution, founded in natural justice, requires that people under co-ordinate liabilities must share the burden pro-rata. He then stated that:

> Although the plaintiffs have chosen not to pursue any of the other directors, the statutory liability which the Plaintiffs rely upon is a joint and several liability created

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239 Ibid

240 Ibid

241 (1998) 8 NZCLC 261,581, 261,587

242 Section 37(6) was also considered in *Westpac Banking Corporation v Savin & Ors* (1986) 3 NZCLC 99,713. There Westpac failed to comply with the requirements of section 37 with regard to a number of unit trust investments. While the court was prepared to grant relied under the Illegal Contracts Act it was of the view that some investors may have preferred to rely on section 37(6) for repayment (261,112) Given that most of the subscribers were unaware of their rights under section 37(6), Doogue J held that a formal notice was necessary. This would say that validation of the allotments can be effected, but that the option for repayment under section 37(6) is also available.

243 (1999) 8 NZCLC 262,026

> by statute. It is a liability that directors of a company share. In those circumstances the proper and just result, supported by authority, is for there to be a right of contribution between the Defendant and his co-directors.[244]

Master Venning also considered that the right to contribution was not affected by any criminal liability that a director may have.[245] However, if a director was found liable for a misstatement in an advertisement it did not necessarily follow that he or she could seek contribution from the other directors for a breach of section 56 (the civil liability provision).[246]

Another decision on section 37 (6) of the 78 Act is *Robinson v Tait* [2002] NZLR 30 (CA). Here, Fortex Group Limited received subscriptions from employees for securities to be issued. No prospectus was issued and thus all subscriptions were required to be kept in a trust account and repaid to subscribers. This did not happen and hence Fortex and all of its directors were jointly and severally liable to repay subscribers under section 37 (6) of the 78 Act. The employees settled their claim against Fortex and sued the directors for the balance of monies owing. The Court of Appeal held that the directors' liability to repay was not extinguished by the settlement with Fortex. Section 37(6) creates joint and several liability and although the settlement might have extinguished joint liability it did not extinguish the directors several obligations which were additional to the joint obligation and continued after release of the joint obligation.

4.9.9 Relief orders in respect of Section 37

A failure to comply with section 37(1)-(3) may have serious consequences not only for the issuer, the directors and the promoters involved but also for subscribers and third parties. While the courts have been careful to narrowly prescribe those contracts which will form part of the allotment to be avoided under section 37(4), there is still the potential for other contracts to be declared invalid due to their interdependence with the avoided allotment. In general, contracts with third party financiers are unlikely to be avoided. However, where the financier has a greater involvement in the scheme the associated loan agreements may also be declared invalid.

For those instances where the avoiding of an allotment will prejudice rather than assist subscribers the courts have been prepared to use the Illegal Contracts Act to validate the

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244 Id, 262,031
245 Ibid
246 Id, 262, 033

allotment. The courts, however, are concerned to ensure that other parties are not unreasonably affected by any validation so that innocent subscribers cannot take validation for granted.

As of 15 April 2004, a new regime for relief orders in respect of section 37 is established. Where there has been a breach of section 37, an application for relief may be made where the subscription has not been repaid: see section 37AA.

Section 37AC provides for mandatory relief orders. A subscriber, security holder or issuer may apply for such an order. An issuer may seek the subscribers consent to the making of a relief order by notice. There is provision for a compensation order in favour of a subscriber for loss or damage suffered.

Section 37 AH provides for discretionary relief orders on just and equitable grounds: see section 37AH.

It is noted that a similar regime applies in respect of section 37A which deals with voidable irregular allotments.

4.10 Previously Allotted Securities

A number of cases under Part II of the Act have involved offers of shares that have been previously allotted to a person and are then onsold.[247] For example, *Barclay's New Zealand Limited v Gillies* involved debt securities, which had been previously issued and then were onsold by Barclay's.[248] *Orr v Martin* involved an offer advertised on 2 September 1987 with the company incorporated on 20 October 1987 (appropriate timing!) with the shares initially allotted to two officers of the company. These shares were then onsold to subscribers on 21 October 1987. The shares were clearly allotted with the intention of offering them to the public.

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247 Under sections 58 and 65 of the Companies Act 1993 a company may buy-back its shares. A company is required to cancel the shares which have been repurchased (section 66) but may hold up to five per cent of its shares as treasury stock (section 67A(1). This treasury stock may be reissued (section 67C). P. McKenzie, "Share buy-backs and the disclosure requirements of the Companies and Securities Acts" [1994] NZLJ 455 notes that "treasury shares" when reissued may need either a prospectus or disclosure as required under sections 6 or 6A.

248 (1990) 5 NZCLC 66,659.

Section 6 provides two ways in which such offers may be brought within Part II. The first deals with recently issued securities.

Section 6(1) provides that, subject to the other provisions in that section, nothing in sections 33, 34, 37 to 38A, 38C to 44, and 44B to 59 of the 78 Act applies to securities that have been previously allotted.

Section 6(2) provides that previously allotted securities have to comply with all the provision of the 78 Act if the securities were originally allotted with a view to being offered for sale to the public in New Zealand, and the security had not been previously offered for sale to the public in New Zealand or to the public outside New Zealand under an application regime under Part 5.

Section 6 (2AA) contains special provisions for overseas offers.

Section 6(2A) requires previously allotted units in unit trusts to comply with Part II.

Section 6(5) provides a presumption that securities were allotted with a view for sale to the public if the securities were offered to the public within six months of the allotment (section 6(5)(a)), or if the securities had not been fully paid for at the time the offer was made (section 6(5)(b)). In *Dodge v Snow* (1999) 8 NZCLC 261, 803, Master Venning held (in the context of a summary judgment application) that the defendant director had an arguable case that the shares in question were previously allotted securities because the initial issue of shares occurred more than six months before the sale in question.

The second way is under section 6(3). Section 6(3) further extends the application of Part II to offers of previously allotted equity securities or securities convertible in equity. This subsection provides:

> All the provisions of this Act shall apply in respect of an equity security or a security convertible into an equity if the holder or offerer, not being the original allotter, offers the security for sale to the public in New Zealand and *the original allotter advises, encourages, or knowingly assists the holder or offerer in connection with the offer of sale of the security*.

The additional test to determine whether an offer of previously allotted equity securities must comply with the Act is therefore whether there is advice, encouragement, or knowing assistance by the original allotter. These terms are not defined in the Act.

An example may help to illustrate the effect of section 6(3). In late 1989, 70,000,000 ordinary shares held by Brierley Nominees Limited in Air New Zealand were offered for sale to members of the public. On the inside cover of the Offering Memorandum a statement was placed which read, in part:

> This Offer Document is dated 8 September 1989. Under New Zealand securities legislation, this Offer Document is not required to be registered as a prospectus.

Brierley Nominees Limited's offer of Air New Zealand shares, contained the following statement on page A1: "Brierley Investments Limited and the Directors of Air New Zealand have taken all reasonable care to ensure that all information contained in this Offer Document is accurate and not misleading and have approved the information contained in this Offer Document". In addition the second volume accompanying the Offer Document was Air NZ's 1989 Annual Report, which in its presentation was clearly intended to assist with the offer of the shares. Assuming the Directors were acting with appropriate authority, then it is clear that the original allotter (Air New Zealand Limited) would have been, at the least, "encouraging, and knowingly assisting" the offer of the sale of the shares. As a result, the section 6(3) would have required Brierley Nominees Limited to comply with the terms of the Act. (Although they were not required to do so, Brierley Nominees Limited in fact complied with the Act, presumably as a matter of prudence).

Section 6(3) has widened the potential for a sale of shares to be caught by the terms of the Act. For example, a company may provide access to financial information, provide a preview as to its future plans, or allow a due diligence exercise to be carried out with the knowledge of the holder's intentions to sell previously allotted shares. In such cases the company would, in the least, be "knowingly assisting" the holder under the terms of the section 6(3). As section 6(3) refers specifically to assistance being given in connection with the offer or sale of *the* securities the company would need to have some knowledge of the specific securities being offered. However, it may be argued from the wording of s 6(3) that the original allotter would not need to know that the shares were to be offered to the "public" since s 6(3) only requires the assistance be in relation to "the offer or sale of the security" and does not require that the original allotter is aware the offer is to be made to the public.

Section 6(3) is narrowed to a certain extent by section 6(4), which provides safe harbours. Offers that are required to be made under the terms of the articles of association or constitution do not come within the terms of section 6(3), nor are offers caught where the holder of the shares receives $200,000, or less, in the space of twelve months. Offers to not more than six members of the public are also exempt from section 6(3). To determine whether or not there has been an offer to more than six members of the public, section 6(6) deems an offer to have been made to more than six members of the public where more than six persons “acquire an interest, whether direct or indirect, in securities of the same class as offered”.

Another addition to the provisions which has widened the reach of the Act in relation to previously allotted securities is section 6A. This section applies to previously allotted securities which are not caught by section 6(2), (2AA), (2A) and (3) and which have been offered to the public. Section 6A implies a term into the offer of such securities that, except to the extent disclosed for the purposes of the offer, “the offerer has no information in relation to the original allotter that is not publicly available and that would, or would be likely to, affect materially the price of the security if it were publicly available”. This is a word for word reproduction of the definition of “inside information” contained in the section 2 of the Securities Markets Act 1988.

As to section 6A: First, unlike section 6(2) and (3), which apply only to equity securities, section 6A applies to *any security* which comes within the wide definition of the “security” in the Act. Accordingly, sales of participatory securities or debt securities would come within the ambit of this provision.

Second, section 6A may require more extensive disclosure of information for offers of previously allotted securities than that required for the original offer. The schedules to the Securities Regulations 1983 set out the specific matters that must be disclosed in a prospectus for an equity, participatory or debt security. One provision in each of the schedules is that the prospectus must disclose, “[P]articulars of any material matters relating to the offer of securities” which have not otherwise been disclosed.[249] This requirement refers to the offer itself, whereas section 6A requires in effect requires disclosure of non-public information that “would, or would be likely to, affect materially *the price* of the security if it were publicly available”. The number of factors that could affect the price of a security could be quite large, perhaps in excess of material matters that would relate to the original offer. Section 6A also means that an offerer could not necessarily rely upon the information set out in the original prospectus, even if the sale of the securities took place soon after the original allotment.

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249 Clause 40, First Schedule.

Third, this provision cannot be contracted out of by the parties since section 4 provides: “The provisions of this Act shall have effect notwithstanding anything to the contrary in any other enactment or in any deed, agreement, application, prospectus, registered prospectus, or advertisement”.

5. Continuing Disclosure Requirements of Public Companies

Disclosure requirements are imposed on issuers by statute (via the Companies Act 1993, the Financial Reporting Act 1993 and SMA), and by contract (via the Listing Agreement between the NZX and the listed company which incorporates the NZX Listing Rules).

5.1 Companies Act 1993

Under the Part XII of the Companies Act 1993, companies are required to disclose certain limited information. Some of this information is kept by the Registrar of Companies and the company and is available to the public (“public information”). Certain other information is kept by the company alone and must be made available to shareholders on request. An annual report must be sent to shareholders: section 209 Companies Act 1993.

Public Information

Section 215 of the Companies Act 1993 states that every company must keep the following documents available for inspection by the public on request: certificate of incorporation or registration; constitution (if any); share register; full names and residential addresses of directors; registered office and address for service: s 215. This information is also held by the Registrar of Companies and may be inspected by any person. In the case of listed companies, full details of shareholders are not kept by the Registrar. An annual return must be also be delivered to the Registrar of Companies: s 214.

Shareholder Information

Companies must keep certain records available for inspection by any shareholder on request: s 216. These include: minutes of shareholder meetings and resolutions; written communications to shareholders over the last 10 years; certificates given by directors under the Act and the interests register.

5.2 Companies (Registration of Charges) Act 1993 and the Personal Property Securities Act 1999

The Companies (Registration of Charges) Act 1993 required the Registrar of Companies to keep a register of company charges and provided for each company to keep a separate register of charges. It was abolished by the Personal Property Securities Act 1999 (PPSA). The position now is that charges over land are registered via the applicable real estate legislation and charges over personal property are registered under the PPSA.

5.3 Securities Act 1978

In addition to the requirement under the Companies Act 1993 to keep a share register, issuers are required under the 78 Act to keep a register of all securities issued by the company: s 51. The register must contain particulars of the security and the security holder and be audited annually. The register may be inspected by shareholders without fee and by any other person on payment of the prescribed fee.

5.4 Securities Markets Act 1988

The SMA imposes a range of disclosure obligations on listed issuers.

5.4.1 Continuous Disclosure by Public Issuers

A statutory continuous disclosure regime for public issuers was first introduced on 1 December 2002 in Part 2, Subpart 1 of the SMA. This law was subsequently amended and the new amendments became effective on February 29 2008. The purpose of the subpart (now spelt out in section 19A) is to provide for appropriate continuous disclosure by public issuers of “material information” (defined in section 3) that is not “generally available to the market”: see section 4 of the SMA. Section 19B imposes a statutory obligation on public issuers to disclose in accordance with the NZX Listing Rules. The NZSC is given the power to make orders requiring disclosure where it is satisfied that a public issuer has contravened a continuous disclosure obligation: see section 42B. Failure to comply is a criminal offence: section 42J.

5.4.2 Disclosure of Relevant Interests by Directors and Officers of Public Issuers

Part 2, Subpart 2 of the SMA contains a regime for the disclosure of relevant interests by directors and company officers in a public issuer or related body corporate: see especially, section 19U. The term "director" is given an extended definition in section 2 of the SMA to catch "any person occupying the position of director by whatever name called". The term "officer" means, inter alia, "a person, however designated, who is concerned or takes part in the management of the public issuer's business". The term "relevant interest" is defined in section 5 of the SMA. The definition is expansive and does not turn on the holding of a given percentage (unlike the substantial shareholder disclosure regime where a 5 per cent shareholding is the trigger for disclosure). The term "related body corporate" is defined in section 5(7) of the SMA.

The obligation imposed by this Subpart is to disclose to the registered exchange and the public issuer via the interests register maintained by the public issuer under section 19Z of the SMA. Failure to comply is an offence: see sections 19ZD and ZF. The NZSC is empowered to make disclosure orders under section 42B and there is an offence of failing to comply with such orders: section 42J.

5.3.2 Disclosure of interests of Substantial Security Holders in Public Issuers

Pursuant to the Securities Markets Act 1988 (SMA), the requirements with regard to substantial security holders only apply to substantial holdings in a public issuer. The substantive provisions are contained in Part 2, Subpart 3 of the SMA. These provisions are intended, inter alia, to ensure disclosure by persons with substantial interests in the company or their nominees: see section 20. A substantial security holder is a person who has an interest in 5 per cent or more of the voting securities of the company. Persons who are substantial shareholders must give notice of such interest (as well as any change in such interest), to the issuer and the registered exchange. Such notice must be given in the prescribed form and contain the prescribed information. The issuer is required to keep a register of all notices filed by substantial security holders: section 35C of the SMA. This register is open for inspection by members of the company and members of the public.

Various carve outs are created in sections 30-33. The most useful is the exemption for nominee companies.

Both the NZSC and public issuers have the power to require disclosure of relevant interests: see sections 34-35B. Further, the NZSC has the power to make disclosure orders where it is satisfied that the person has contravened a substantial holding disclosure obligation: section 42B. In addition, the NZSC may seek a pecuniary penalty order and declaration of contravention: section 42R.

Failure to comply with the substantial holding disclosure obligation is an offence: see section 35BA.

5.4 Disclosure Requirements under the Financial Reporting Act 1993 (FRA)

Part II of the FRA (the financial reporting provisions), applies to issuers of securities and companies listed on the NZSE.[250] The financial reporting provisions complement the provisions of the Companies Act 1993 dealing with accounting records, audit and disclosure to shareholders. Pursuant to the FRA, standards for financial reporting are now approved outside the accountancy profession and the standards have legal backing. In the terminology of the FRA, parties to a Listing Agreement are "reporting entities". The financial reporting requirements for listed companies may be summarized as follows:

- **Balance Date:** The balance date is 31 March or such other date as the directors decides to adopt.

- **Financial Statements:** Financial statements must be presented within 5 months after balance date. These must comprise: a balance sheet; a profit and loss statement; a statement of cash flows, and, notes or documents giving information relating to the balance sheet, statements, or account.

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250 For an early review of this legislation, see T. van Zijl, "Financial Reporting Legislation" in G. Walker and B. Fisse, eds, *Securities Regulation in Australia and New Zealand*, 1st ed (1994), 420-443.

- **Group Financial Statements:** These are to be in the form of consolidated statements and must incorporate the financial statements of every subsidiary of the reporting entity. An issuer must ensure that its balance date and those of its subsidiaries are the same.

- **Compliance with Generally Accepted Accounting Practice:** Financial Statements must comply with GAAP but if the statements do not give a true and fair view then the directors must add sufficient information so as to provide it.

- **Overseas Companies:** If the Registrar is satisfied that the financial statements of an overseas company comply with home country requirements and those requirements are substantially the same as those of the FRA then such statements are deemed to comply with GAAP. Pursuant to s 19 of the FRA overseas companies must register financial statements with the Registrar of Companies. The Registrar has issued a Practice Note containing the Registrar's interpretation of s 19(1)(c) of the FRA.

- **Audit and Registration:** The financial statements of an issuer must be audited and the statements and auditor's report delivered to the Registrar.

- **Auditor's Report:** Requirements of the auditor's report are contained in s 16 of the FRA.

- **Annual Return:** An annual return must be delivered to the Registrar as required by s 214 Companies Act, 1993.

- **Offences:** Fines not exceeding $100,000 may be imposed for failure to present the financial statements within the prescribed 5 months.

4.5 NZX Disclosure Requirements

The NZX Listing Rules can be viewed at the NZX website. The version of the Listing Rules referred to in this part of the Booklet is that of May 2006. Section 10 of the NZSE Listing Rules contains various requirements for disclosure by listed issuers.

Continuous Disclosure of Material Information

The term 'material information' is defined in section 1 of the NZX Listing Rules (February 2007 version) as information in relation the issuer that "a reasonable person would expect, if it were generally available to the market, to have a material effect on the price of Quoted Securities of the issuer and relates to particular securities, a particular issuer, or particular issuers, rather than to securities generally or issuers generally." There is also a further definition of information "generally available to the market". Listing Rule 10.1.1 then contains an obligation to release material information to the NZX subject to a set of "carve outs". Note that this obligation is backed by legislation: see section 19B of the SMA. The best guidance on the interpretation of this listing rule is the Australian equivalent upon which it is based, the Australian Stock Exchange LR 3.1: see CCH Australia Limited, *Annotated Listing Rules* (Sydney: CCH Australia Ltd).

Further Information

LR 10.1 also requires issuers to disclose arrangements where members of the public might reasonably consider the directors have a conflict of interest.

Information Upon Major Change of Control or Direction

LR 10.3 empowers the NZX to require the preparation of an information memorandum and the distribution of it in such manner as the NZX determines in the above-captioned circumstances.

Preliminary Announcements

NZX LR 10.4 requires each issuer to make a preliminary announcement through the NZX before the release of each annual report and before the release of each half yearly report.

Annual and Half Yearly Reports

LR 10.5 contains requirements for the issuance of annual and half yearly reports to the NZX.

LR 10.5.1 requires that each issuer issue an annual report to the NZX and Quoted Security Holders within three months of the end of each financial year of the issuer. The annual report must contain all information required by law (such as the identity of substantial security holders pursuant to section 26 of the SMA), information required in a preliminary announcement by LR 10.4.2, information as required by LR 10.5.3 (disclosure of Principal Security Holders and director's holdings), LR 10.5.4 (Appointed directors) and LR 10.5.5 (Changes in Reporting Period). In addition, the financial statements in the annual report must be audited.

LR 10.5.2 requires issuers to issue half yearly reports to the NZX and Quoted Security Holders.

Compliance with the Financial Reporting Act 1993

LR 10.6 requires issuers to comply with the provisions of the FRA in respect of financial statements.

Announcements of Material Changes

LR 10.7.1 requires notification to the NZX of any proposed change in the general nature of the business of an issuer or its group.

LR 10.7.2 requires notification to the NZX of any acquisition or disposition of a beneficial interest in 5 per cent or more of the voting securities of another issuer. This requirement is additional to the obligations imposed by Part II of the SMA.

LR 10.7.4 requires notification to the NZX of the disposition or acquisition of assets where the gross value of those assets represents more than 10 per cent of shareholder's funds.

Other Information to be notified to the Exchange

LR 10.8.1 requires certain other information to be advised to the NZX as soon as the information is first available: see LR 10.8.1 (a)-(h).

Disclosure of Relevant Interests in Securities

LR 10.9.1 provides that an issuer shall, on request by the NZX, exercise its powers under ss 28-29 of the SMA (public issuer may require disclosure of substantial security holder's interests). LR 10.9.2 enables the NZX to request an issuer to provide any information so obtained to the NZX for public release.

Announcements by Mining Issuers

The Listing Rules make special provision for announcements by mining issuers. Of particular significance is the requirement to provide quarterly reports: LR 10.10.4.

6. Fraud, Manipulation and Insider Trading

6.1 NZX Listing Rules

The relationship between the NZX and the listed issuer is contractual. Pursuant to such contract, the NZX has the discretionary power to cancel or suspend a listing: LR 5.4.2. This power may be exercised where a false market in the issuer's securities exists: LR 5.4.3 (a). Further, pursuant to Section 10 of the Listing Rules (Disclosure and Information), issuers are obliged to release relevant information to the NZX to the extent necessary to prevent the development or subsistence of a market for their securities which is materially influenced by false or misleading statements emanating from the issuer or other persons in circumstances in each case which would give such information credibility: LR 10.1.1 (c). Breach of this rule might invite the sanctions contained in LR 5.4.2.

6.2 Common Law Remedies

New Zealand is a common law country. Section 65 of the Act provides that nothing in the Act shall limit or diminish, *inter alia*, any liability that any person may incur under any rule of law. Hence, common law remedies remain unaffected by the Act. The most important common law remedies are actions for rescission of contract, deceit, negligent misrepresentation and breach of contract.

6.3 Statutory Offences

6.3.1 Fair Trading Act 1986

6.3.2 Introduction

As of 29 February 2008, the SMA contains new provisions dealing with market manipulation and misleading or deceptive conduct generally. The latter prohibition is known as the general dealing misconduct prohibition - see section 13 - and this provision has an extra territorial scope: Here, it is important to note that section 13 (2) states that in order to "make the position clear, this section applies more broadly than the rest of this Part and so applies to securities whether listed or non-listed and to all dealings in securities (not only trading)." This means that section 13 applies to conduct under the 78 Act and, indeed, to any dealings in securities of whatsoever kind.

There remains, however, a general statutory remedy in the Fair Trading Act 1986. Section 9 of the Act prohibits conduct in trade which is misleading and deceptive and s 43 gives the Court a wide discretion in awarding appropriate remedies.

.As of February 2008, however, there exists an important qualification to the application of the Fair Trading Act 1986 in relation to securities. Section 19 of the SMA states that a "court hearing a proceeding brought against a person under the Fair Trading Act 1986 must not find that person liable for conduct that is regulated by this Part if that person would not be liable for that conduct under this Part." Section 19, therefore, has the practical effect of rendering inapplicable the application of section 9 of the Fair Trading Act where securities are involved. However, case law under the Fair Trading Act 1986 and cognate provision will remain of assistance in interpreting section 13 of the SMA. The best guidance on the application of section 13 of the SMA, however, is the case law on section 1041H of the Australian Corporations Law.