
Where to from *Ingot Capital Investments v Macquarie Equity Capital Markets*?

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*The Court of Appeal in *Ingot Capital Investments v Macquarie Equity Capital Markets* (2008) 73 NSWLR 653 recognised that due diligence certification is capable of being misleading and deceptive conduct in terms of the *Corporations Act 2001* (Cth), s 1041H(1), and that such conduct may indirectly cause the plaintiff investor's loss where the plaintiff is a "passive victim of misleading conduct" (at [617]). No further investment decision by the plaintiff affects their loss because either loss flows regardless or any investment decision is effectively removed from the investor or reversed by the effect of the misleading conduct on a third party. In both cases, there is no break in the chain of causation and the investor can be regarded as a passive victim. The misleading conduct comprised in the due diligence certification must be so material that "by its very nature" (at [12]), it causes loss or would result in no prospectus being issued or one so different that no investor including the plaintiff would invest (at [26], [80], [591]) It is the view of the author that the approach of the Court of Appeal throws up the potential for other sign-off processes to be subject to court scrutiny in misleading conduct claims in light of how banks structure and market transactions, both in direct and indirect causation cases.*

1. INTRODUCTION

The decision of the Court of Appeal in *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* (2008) 73 NSWLR 653¹ has important ramifications for due diligence committee members. Due diligence committee members comprise representatives from banks, accountancy firms, law firms, other professional advisers, issuers of corporate and structured securities, their directors and any person exposed to potential liability under the *Corporations Act 2001* (Cth), s 729 or s 1041I. Section 729 contains a table of those persons liable on a disclosure document and s 1041I permits recovery against any person engaging in misleading, deceptive or dishonest conduct contravening ss 1041E-1041H of the Act.

The significance of the judgments of McDougall J in the Supreme Court and the judgments of Ipp JA, Giles JA and Hodgson JA in the Court of Appeal, resonates fully from a reading of all the judgments. That daunting task, given that the hearing lasted 108 days in the Supreme Court, may have obscured some of the important messages for participants in the debt and equity markets.

This article is not intended to be a synopsis of all the findings of the Court of Appeal but focuses on one of the claims made against the bank: a misleading and deceptive conduct claim for damages based on due diligence representations and certification (sign-off)² under s 1005 of the *Corporations Law* for a *Corporations Law*, s 995 contravention.³ The plaintiff investors claimed that the bank's due diligence representations and sign-off to the board that nothing had come to their attention causing them to believe that there was a material misstatement or omission in the draft prospectus, was

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¹ On appeal from *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* [No 6] [2007] NSWSC 124 (McDougall J).

² Sign-off is the certification given by the due diligence committee that the statutory test for prospectus disclosure has been met.

³ The equivalent is now a *Corporations Act 2001* (Cth), s 1041I damages claim for a *Corporations Act 2001* (Cth), s 1041H(1) contravention (misleading and deceptive conduct).



misleading in light of material changes in respect of four matters.⁴ This claim failed on two grounds. First, the representations and sign-off were found not to be misleading and secondly, causation was not proved.

My commentary is in relation to banks but has equal application to other members of a due diligence committee. Accountants, lawyers, issuers of corporate securities and their directors can be read in place of “banks” in this article as regards their respective involvement. It also has relevance for the equivalent contravention under s 12DA(1) of the *Australian Securities and Investments Commission Act 2001* (Cth).⁵

A. Due diligence

“Due diligence” involves collecting, organising and checking information relating to the issuer of a “financial product”,⁶ the financial product itself, and such information that the investor needs to make an informed investment decision. In the context of securities,⁷ due diligence aids the discharge of the disclosure obligation in s 710 of the *Corporations Act* for marketing securities to investors. The marketing document is the prospectus, and the statutory test for prospectus disclosure is information that investors and their professional advisers would reasonably require to make an informed assessment of certain matters that are known or ought reasonably to have been obtained by making inquiries (s 710). A proper discharge of this duty to disclose may require a due diligence process to be undertaken and this is standard banking practice where new issues are brought to market. Although there is no statutory duty to undertake due diligence, where this is done in purported discharge of the statutory duty to disclose, s 1041H requires that the conduct is not misleading or deceptive.

The persons responsible for acquiring the knowledge to make proper disclosure or conducting a due diligence are the issuer, the directors of the issuer, the underwriter, sellers, persons making statements in the prospectus and professional advisers, as set out in s 710(3). If loss is suffered as a result of a defective prospectus (that is, one that contains a misleading or deceptive statement or omission contravening s 728), the due diligence members can be sued (s 729). So a defect in the prospectus itself founds a statutory cause of action if found to be misleading or deceptive and one that caused the plaintiff’s loss. The purpose of the due diligence process is two-fold. It helps satisfy the statutory requirement for disclosure and even if it ultimately fails, it acts as a defence if reasonable inquiries were made and a reasonable belief was held that the prospectus was not misleading (s 731).

It is important to distinguish between loss resulting from a misleading or deceptive prospectus and loss resulting from misleading or deceptive conduct outside of a prospectus. The former may give rise to a claim under s 729 and the latter may give rise to a claim under s 1041I. There is no overlap between the two. A s 729 action is primarily confined to loss resulting from a misleading or deceptive disclosure document and a s 1041I action excludes this specifically (s 1041H(3)). However due diligence is relevant to both actions. It acts as a defence to a s 729 action (s 731) and it is relevant to the objective test applied to determine whether conduct is misleading in terms of s 1041H.

B. Significance of the decision

The decision of the Court of Appeal in *Ingot Capital* is significant for four reasons.

- First, the Court of Appeal recognised indirect causation where the plaintiff is a “passive victim of misleading conduct” (at [12], [82], [617]). Two sub-categories of indirect causation cases were identified by the Court of Appeal. No further investment decision by the plaintiff affects their loss because either (1) loss flows regardless or (2) any investment decision is effectively removed from the investor or reversed by the effect of the misleading conduct on a third party (at [26], [80], [591]).

⁴ The four matters concerned the stop loss proposal, new losses, a special prudential margin and a further Trowbridge report: see *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* (2008) 73 NSWLR 653 at [142] 679 (Ipp JA).

⁵ *ASIC v Maxwell* [2006] NSWSC 1052 (Brereton J), where contraventions were found under both *Australian Securities and Investments Commission Act 2001* (Cth), s 12DA(1) and *Corporations Act 2001* (Cth), s 1041H(1).

⁶ Umbrella term defined in *Corporations Act 2001* (Cth), s 764A(1)(a), (c) to include both securities and derivatives.

⁷ Defined in *Corporations Act 2001* (Cth), s 761A.



The second application focuses on the effect of the conduct on a third party involved in a process of due diligence sign-off. Prior to this decision, an investor would have found it difficult to cite direct authority in support of the proposition that the effect of a sign-off process on a third party, being a process that the investor was not part of, did not have knowledge of or rely on, caused his loss. As a result of the decision in *Ingot Capital*, if disclosure of the misleading conduct would result in a third party such as the board of the issuing entity, not issuing at all or only issuing a prospectus so different that no investor including the plaintiff would proceed with the investment, a claim may exist under s 1041I (at [26]-[27], [80], [591]). Hodgson JA expressed the materiality of the non-disclosure in terms of a fall in the share price, whereas Ipp JA and Giles JA expressed the materiality of the non-disclosure in terms of the effect on the product issuance, but both expressions recognise indirect causation.

In my view, the comments of the judges, though strictly obiter, demonstrate the court's willingness to shift focus from the effect of representations on the plaintiff solely to the effect of due diligence sign-off on a third party whose actions of themselves may cause loss to the investor.

- Secondly, it is my view that this shift in focus may subject other processes within the banks to court scrutiny in the context of misleading and deceptive conduct claims in the future. With a shift to the process of investigation itself (at [74]), which is conducted at a different point in time to the issue of the prospectus, the usual protections afforded by disclaimers in prospectuses and the "mere conduit"⁸ argument may not protect the bank to the same extent.
- Thirdly, a departure from the *Potts v Miller* (1940) 64 CLR 282 measure of damages is appropriate where a plaintiff is "locked-in" to a product purchase, in say an illiquid market (at [177]).
- Fourthly, the decision highlights that the way a case is pleaded can determine its outcome. The Court of Appeal refused to entertain a wider case than the pleadings where this had been stated by the primary judge and agreed to during the hearing (at [60]).

2. THE DUE DILIGENCE PROCESS AS THE MISLEADING CONDUCT

The due diligence process has previously been seen more as a defence to statutory liability for a misleading prospectus but the Court of Appeal in *Ingot Capital* recognised that the due diligence representations and sign-off can itself be pleaded as the misleading conduct. Hodgson JA went further and indicated (at [74]) that the process of investigation itself may be pleaded as the misleading conduct but that is strictly obiter because the claim before the court was not the process of investigation undertaken by the due diligence committee but rather the committee representations and the sign-off resulting from that process.

A. The test

The test of whether conduct is misleading has objective and subjective components. The test is whether, having regard to all the relevant circumstances, there has been conduct that is misleading or deceptive or likely to mislead or deceive. This is a question of fact to be decided looking at the matter objectively and the intention of the defendant is irrelevant.⁹ Silence may constitute misleading conduct where there is a duty to disclose such as that under s 710 in relation to prospectus disclosure but also absent any duty, where the silence is an element of conduct that is in all the circumstances misleading.¹⁰

Where an investor pleads the due diligence process itself, sign-off or individual representations in the due diligence report as the misleading conduct causing loss but absent any direct reliance by the investor, an indirect causation case may lie on the basis that the issuer of the product was misled. If

⁸ The "mere conduit" argument is that the bank is merely passing on management information and relies on what it is told by the management of the issuing entity and makes it clear that it disclaims the information in the disclosure document: *Yorke v Lucas* (1985) 158 CLR 661 at 666, endorsed in *Orix Australia Corporation Ltd v Moody Kiddell & Partner Pty Ltd* [2006] NSWCA 257.

⁹ *Taco Co of Australia Inc v Taco Bell Pty Ltd* (1982) 42 ALR 177.

¹⁰ *Commonwealth Bank of Australia v Mehta* (1991) 23 NSWLR 84 at 88.



the issuer's actions, as a result of the disclosure of the misleading conduct, would have the effect of removing or reversing an investor's decision to invest, so causing loss to the investor, a claim may lie under s 1041I. Later cases have identified the subjective factors below that influence the application of the test.

1. *Inequality*: One decision¹¹ takes this concept beyond whether the investor is a sophisticated investor and recognises that inequality may exist because the investor, while sophisticated in certain areas may not be with regard to specific concepts. In the context of highly structured products, this factor should inform bank processes to take account of the lack of knowledge of investors as to the structure/risks of complex products.
2. *Prior dealings*: Any long standing or prior dealings between the parties in the form of discussions or prior transactions may affect a finding of whether the conduct pleaded was misleading.¹²
3. *Surrounding express statements*: This factor is directed at disclosing the weaknesses or risks to an investor as well as the advantages or enhancements, to present to complete picture.¹³ Bank responses to investor queries are relevant, particularly if they establish investor concerns, potentially falsify prospectus representations or require a due diligence process to cover certain information.
4. *Materiality*: The focus of the disclosure or non-disclosure or the investigations must be material to found a reasonable expectation that they will be made or carried out.¹⁴
5. *Complexity and general availability of the subject matter*: The more highly structured a product, combined with an investor's lack of knowledge of it,¹⁵ and the unavailability of finding out information except through investigation or disclosure may affect a finding of whether the conduct pleaded was misleading.
6. *Knowledge*: In *Ingot Capital* (at [275]) the Court of Appeal followed the majority judgment in *Butcher v Lachlan Edler Realty Pty Ltd* (2004) 218 CLR 592 at 604-605, that although contravention of s 995 of the *Corporations Law* and causation of loss or damage are separate questions, the knowledge of the individuals to whom a representation is made goes to whether conduct is misleading and is prior to and distinct from whether the individuals were in fact misled when "causation" is in issue. The identified individuals rather than the class into which they fall, and any disclaimers and other circumstances qualifying the character of the conduct are all relevant in analysing whether conduct is misleading. If the individuals knew the true facts or were indifferent, there can be no misleading conduct.¹⁶ In effect, the onus is on the defendant to prove the plaintiff knew of the true situation (*Ingot Capital* at [81]).

The Court of Appeal found no misleading conduct on the part of the bank in giving sign-off or giving any of the due diligence representations in the report leading to sign-off because the four matters put forward as the misleading representations were held not to be misleading (at [72] (Hodgson JA), [595] (Ipp JA with whom Giles JA agreed as to these findings), drawn from [470], [484], [542], [582])). Ipp JA and Giles JA also held that the case against the bank failed on a second ground because all the board members knew the true facts (at [50], [595], [611], [624]). In the view of Ipp JA and Giles JA, the board did not rely on the correctness of any of the representations as to no material changes in the due diligence report, and did not rely on sign-off

¹¹ *Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452.

¹² In *Rohesa Nominees Pty Ltd v Rossett Pty Ltd* [2004] FMCA 565, the prior dealings meant that the agent knew of the purchaser's desire to obtain a secure property which led to a reasonable expectation of disclosure of the tenancy of the property.

¹³ In *Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452, the directors made statements to holders regarding the adoption of a demutualisation plan and the court found that it was reasonable for members to expect full disclosure of any material information. Compare also the failure of the financial advisor in *Paige v FPI Ltd* [2001] NSWSC 627 to warn the plaintiffs of the serious risk to their capital in the investment recommended and the reasonable expectation that such risk would be disclosed.

¹⁴ *Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452.

¹⁵ *Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452.

¹⁶ Followed in *Orix Australia Corporation Ltd v Moody Kiddell & Partner Pty Ltd* [2006] NSWCA 257.



to convey the absence of material changes because they all knew of the true situation.¹⁷ Ipp JA went further and found (at [619]) that the case also failed because reliance by the investor was not proved in line with *Digi-Tech (Australia) v Brand* [2004] ATPR 46-248.

Hodgson JA declined to express a view on this second ground of failure (at [72]), but indicated that if the process of investigation had been pleaded as the misleading conduct in that the committee had not carefully investigated the matters, misleading conduct and reliance by the board could possibly have been proved (at [73]).

From a bank's perspective, the significance of each of the subjective factors depends upon the particular product and the particular end-investor or class of investors to which the product was marketed or the third party issuer in a case of indirect causation, where the particular end-investor can be regarded as passive.

B. Test for misleading conduct compared to the misleading prospectus standard

The characterisation of conduct as misleading under s 1041H of the *Corporations Act* is a different test to the characterisation of a statement in a prospectus as misleading under s 728 of the Act. Subjective factors may operate to cut back or enlarge the scope for finding misleading conduct outside the prospectus under s 1041H, whereas prospectus disclosure is based on the wide-ranging "reasonable investor" standard in s 710, which requires information "it is reasonable for investors and their professional advisers to expect to find in the prospectus".

Prospectus disclaimers and an argument that the bank is a "mere conduit" of information provided by other sources are relevant to a bank's prospectus liability. The Court of Appeal in *Ingot Capital* agreed (at [290]) with McDougall J that the bank was a "mere conduit" of management information, and that its representations in the prospectus, bolstered by the prospectus disclaimers were not misleading.

These arguments may be less relevant to a bank's liability for due diligence sign-off for two reasons. First, prospectus disclaimers apply to information disclosed in the prospectus and not information disclosed to a due diligence committee, the suppression of which or the lack of further investigation about, may itself make the process and/or the sign-off misleading. The important point regarding this shift to focus on process sign-offs is that the process of sign-off itself is under scrutiny as the misleading conduct. The idea that you can simply avoid asking certain questions in the due diligence process will not avoid liability if the process itself is pleaded as the misleading conduct. Disclaimers in the prospectus will not avoid the characterisation of a process as misleading if it is inadequate in its investigations. Secondly, the "mere conduit" argument may have less application to the characterisation of the due diligence process or sign-off as misleading because the focus is on the process of checking information as a result of its investigations and that process is different depending upon the type of securities being issued.

As regards the process itself, information may be provided by non-bank sources but if material changes to that information are disclosed and not further investigated or not disclosed in the due diligence report, then the "mere conduit" argument does not deprive the due diligence process or sign-off of its misleading nature. Further, the due diligence process is different depending upon whether the bank is arranging the issue of corporate securities or structured securities. Disclosure for corporate securities focuses on the state of the company and relies in large part on management disclosures and the work of the issuer's accountants and lawyers based on those disclosures.

Structured securities are different to corporate securities because the balance sheet and operations of the SPV¹⁸ issuer are essentially limited to acquiring assets and issuing and servicing the financial product. Structured products are the bank's own making, using a pool of assets provided by an internal or external originator and serviced by either the same originator or another entity. The quality of the

¹⁷ In this regard see *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* (2008) 73 NSWLR 653 at [46] per Giles JA: "Misleading conduct is a matter of fact, not of legal attrition of a board member's knowledge to the corporation."

¹⁸ Special Purpose Vehicle or issuing entity in securitisation transactions.



collateral pool is the subject of disclosures by the portfolio manager or originator to the due diligence committee, but the risk of these securities is removed from the credit of the originator and is more dependent on the features of the product.

Due diligence for structured securities focuses on the quality of the portfolio collateral, the structural features of the issuance and how that affects risk since the issuance is part of a securitisation and divorced from the credit quality of the originator of the collateral. As structuring and its related disclosure in terms of product features falls within the bank's area of responsibility, the "mere conduit" argument has less scope.

In this context, where a claim is made that the structured security was structured for a particular end-investor and was unsuitable for that end-investor, the examination of the internal bank processes may throw up questions as to whether the process was carried out properly so as to test whether the structure was robust enough to match the risk/return appetite of the particular investor. All committee members, within their sphere of responsibility, must ensure that they ask the right questions, take careful notes of the responses provided, follow up red flags and be mindful that the test of disclosure takes account of subjective factors.

The decision in *Ingot Capital* potentially puts the bank's participation in the due diligence process sign-off under the spotlight. This has important ramifications for potential bank liability.

3. INDIRECT CAUSATION

A. Categories

Ingot Capital defined two applications of case of indirect causation where an investor may claim misleading and deceptive conduct against a party whose contravention has indirectly caused the investor's loss (at [35]).¹⁹

The distinction between direct and indirect causation is explained in the judgment of Giles JA (at [12]) and affirms the distinction drawn in *Digi-Tech*, between two categories of cases. The first category is the *Janssen-Cilag Pty Ltd v Pfizer Pty Ltd* (1992) 37 FCR 526 type case,²⁰ where the misleading conduct "by its very nature, causes the plaintiff's loss",²¹ and reliance by the investor need not be proved. It is the so-called indirect causation case because causation is established by proving that a third party relied upon the misleading conduct and that party's reliance caused the investor's damage. The second category of case involves positive conduct on the part of the investor, which "forms a link in the causation chain"²² and reliance must be proved. Otherwise, in the absence of proof of reliance, a plaintiff could claim for a loss despite knowing the truth or being indifferent as to the truth (*Ingot Capital* at [22]).

As regards the first category of case, where the plaintiff is a "passive victim of misleading conduct" (at [617]), two applications of indirect causation cases were identified by the Court of Appeal. No further investment decision by the plaintiff affects their loss because either: (a) loss flows regardless; or (b) any investment decision is effectively removed from the investor or reversed by the effect of the misleading conduct on a third party (at [26], [80], [591]). The first application is the *Janssen-Cilag*-type case, where the loss flows regardless, because no action or omission by the plaintiff affects the loss it suffers (*Ingot Capital* at [617]). The misleading conduct causes loss that is "dictated by the laws of nature" (at [19]). The second application recognised by the court is enlivened where the investment decision of the plaintiff is removed or reversed because the misleading conduct would result in no prospectus being issued or one so different that no investor, including the plaintiff, would invest or the investor would accept an offer to cancel their subscription, so reversing their investment decision (at [26], [80], see esp [591]). "But for" causation is not sufficient unless the misleading conduct can be shown to have provided not only an investment opportunity but that its

¹⁹ Applying the same concept of causation to contraventions of the *Corporations Act 2001* (Cth), ss 995, 996.

²⁰ Consumers were misled to buy less of the plaintiff's product.

²¹ *Digi-Tech (Australia) v Brand* (2004) ATPR 46-248 at [155].

²² *Digi-Tech (Australia) v Brand* [2004] ATPR 46-248 at [156].



disclosure would have resulted in such investment opportunity being removed by a third party after the investor had committed to take up the opportunity.

Ipp JA and Giles JA were divided on whether the cases before the court did or did not require reliance to be proved by the end-investor on the due diligence representations or sign-off at different points but the whole of the court recognised the second application of indirect causation. Ipp JA and Giles JA characterised the misleading conduct comprised in due diligence sign-off on the draft prospectus prior to the investor making application for the notes as falling within the second category of cases (at [22], [619]). Their findings were made on the basis that the investor was not passive, but undertook decision-making to which the due diligence representations and sign-off was material, and so required reliance in like manner to *Digi-Tech*. Causation was not proved and this was put forward by Ipp JA and Giles JA as the second ground for the case against the bank and other due diligence committee members failing (at [50], [595]).

However, as regards the final due diligence sign-off in the final report after the investors had applied for the notes but before issuance of the notes, Giles JA differed (at [25]) from Ipp JA and regarded the investor as passive, because the investor was already committed and falling within the first category of cases and specifically the second application. The standard market period between an investor committing to purchase a product on the primary market and the issuance of the product to the investor means that an investor is committed on the signing date.

If the final due diligence sign-off had not been given, assuming the board relied on this sign-off and the correctness of some of the representations forming part of this sign-off, this would have been material enough to cause the board not to issue the notes or to issue a materially different prospectus with the result that the investors would not have bought the notes and suffered loss. Reliance by the investors did not need to be proved because the investors were passive sufferers of the misleading conduct of the due diligence committee members. Giles JA found that the case ultimately failed because the board knew of all four matters and was not misled. The board's knowledge "brought failure at the prior point of contravention, as well as in relation to causation of loss or damage" (at [48]).

Ipp JA held that even as regards the final due diligence sign-off, the investor was not passive and failed to prove reliance on the due diligence sign-off.

Hodgson JA found it unnecessary to decide which category of case the facts fell within but indicated that it could have fallen within the second application regardless of whether there was an investment decision on the part of the investors to invest in it (at [80]). Reliance need not be proved, at least so long as the investors did not know the truth (at [82]). Hodgson JA also indicated that if the process itself had been pleaded as the misleading conduct, knowledge of the truth of some of the matters in the due diligence report would not have deprived the conduct of its misleading character if reliance was still being placed on proper investigations having been carried out (at [74]).

B. Future litigation

The significance of this finding is that investors may now be mindful to focus on the final due diligence committee sign-off or process rather than particular due diligence representations to more easily establish materiality and reliance by a third party in indirect causation cases, so as to enliven the indirect causation category of case which does not require the plaintiff to prove reliance on the defendant's conduct. Such a claim can be defeated by knowledge of the plaintiff or the third party of the true situation to negate reliance and break the chain of causation but the onus is effectively on the defendant to prove this knowledge.

4. OTHER PROCESSES WITHIN BANKS

In my view, based on the reasoning of the Court of Appeal with respect to the due diligence process sign-off, other processes within banks may become subject to greater scrutiny.

A. Reverse inquiry deals

The structuring process, where a bespoke deal is structured by a bank in direct response to a reverse inquiry from an investor (that is, investor initiated), may be characterised as misleading and deceptive



if the end-investor's risk/return profile does not inform the choice of product and its features. The subjective factors relevant to whether there is misleading conduct are again relevant where the structuring process itself is pleaded as the misleading conduct.

In structured product litigation, it is arguable that there is inequality with regard to highly structured products vis-à-vis banks and end investors. By way of example, one feature of a product might be its exposure to a top rated index, where default in even one of the names in the index is viewed as remote. This feature may be combined with a second feature, high leverage and potentially increasing leverage with the result that a small number of defaults can wipe out the entire face value of the investment. It is arguable that an investor may not understand the ramifications of this combination of features on the asset side of a security it purchases as compared to the bank structurers.

In the context of a reverse inquiry, it could be argued that the bank's process of choosing a particular product to structure for a particular end-investor is misleading. A reverse inquiry brings this sharply into focus because the conduct is analysed with the investor in mind.

The background to the structuring process, in terms of express statements made by the bank as to the workings of the product in different scenarios, is relevant, as is the content of any investor queries. All statements forming part of the process of structuring a product for the investor, oral and written, together with disclaimers, whether they are communicated via an intermediary or not, need to be analysed in terms of whether they convey high risk or low risk to the particular investor. Given the potentially material consequences and the complexity of the product, the structuring process is critical to the investor's decision to invest.

Later prospectus disclaimers do not prevent liability attaching to this process if it is not conducted properly. The choice of product stage in the context of a reverse inquiry is at an earlier point than the issue of the prospectus. The earlier timing may be critical because, if the statements conveying high risk in a prospectus and related disclaimers are found not to have formed part of the earlier process and the investor's confusion about the product and subsequent purchase was primarily the result of the structuring process, a finding of misleading conduct may be open, bearing in mind the knowledge of the particular investor at the time of purchase. This shifts the onus of proof to the bank to show that the investor was not misled owing to later disclosures and disclaimers in the prospectus.²³

To protect against this potential liability at an earlier stage a bank may need to be careful in its choice of product as regards its suitability and what it conveys to the investor and the directors of the SPV, get an express acknowledgment from the end-investor and the directors of the SPV as to their knowledge of the product's structural features and risks, and be prepared to re-tailor the product in light of feedback from the investor or the SPV directors.

5. Loss

The Court of Appeal allowed the entire loss to be claimed by the investors, not just the difference between the price paid by the investor and the real value of the product at the transaction date. This represents a departure from the rule in *Potts v Miller* (1940) 64 CLR 282²⁴ on the basis that the plaintiff was "locked-in" to a product purchase, in an illiquid market. As Ipp JA states, "conduct may be regarded as causing the entire loss even if, after the acquisition of the assets in question, other causes contribute to the loss" (at [177]).

²³ It was recognised in *Delmenico v Brannelly* [2008] QCA 74 (an *Australian Securities and Investment Act 2001* (Cth), s 12DA(1) case) that statements outside an information memorandum can mislead if the investor's confusion is substantially the product of those statements.

²⁴ The measure of damages under the rule is the difference between the price paid and the real value of the financial product at the time of purchase.



6. PLEADINGS

In financial product litigation, the way the case is pleaded will have a significant impact on the outcome of the case, as it did in *Ingot Capital*. The resulting orders²⁵ are less significant than the findings of the court.

Ipp JA noted that you cannot pick up for one pleaded case, the facts pleaded for another (at [359]), including in defences and cross-claims (at [355]), and that if materiality is an element of the contravention, it needs to be specifically pleaded (at [431]). In cases of omission, what was not disclosed needs to be pleaded, and if that is not clear because the information was dishonestly withheld, that needs to be made clear in the pleadings (at [66] (Hodgson JA)). Dishonesty must be directly alleged to be relied upon,²⁶ acknowledging that there may be tactical reasons not to plead dishonesty due to the terms of any insurance policies of the company and directors. Each breach must be separately alleged along with whether such breach results in direct liability or accessory liability and whether the case is one of direct or indirect causation.

On the facts of the case, if the knowledge or dishonesty of a due diligence committee member at different times had been pleaded in respect of smoothing cover in such a way as to make it clear that the overstatement of the smoothing cover was made to show that the company was not in breach of finance covenants (at [66]) or to deliberately deceive, and the evidence had been that the board was misled, the result may have been different. Instead, the focus was not on the smoothing cover itself but its effect on net assets as a line item in the balance sheet. Due to an off-setting adjustment in the balance sheet to account for the overstatement, the resulting net difference was immaterial, and the argument, as pleaded, failed (at [331]).

While a departure from pleaded issues is a matter for the discretion of the trial judge, McDougall J was found to have exercised his discretion not to entertain a wider case than the pleadings properly and the Court of Appeal refused to set aside that approach in circumstances where this had been stated by the primary judge and agreed to during the hearing (see [60], [460]). The court also refused to entertain a wider case than the pleadings, citing the dictates of procedural fairness, the need for dishonesty or lack of integrity to be pleaded expressly, and the heavy costs of a new trial to permit evidence to be led on a wider case (see [438], [443], [467]). The decision highlights the importance of the pleadings in determining a successful outcome.

7. SUMMARY

The decision in *Ingot Capital* brings the bank's due diligence sign-off under scrutiny, and is bolstered by the court's recognition of a new application of indirect causation. Other sign-offs and processes were not in issue in that case but the decision opens the possibility of other sign-offs and processes being made subject to court scrutiny.

It is my view that the traditional protections and arguments raised by banks may be reduced in their scope when the sign-off or a process is pleaded as the misleading conduct. If the investor has no knowledge of the bank process, there can be no reliance by the investor. However there may be reliance by a third party on the bank process. In the case of a due diligence sign-off, where the board relies on the truth of some of the representations forming part of the sign-off or the process of

²⁵ The plaintiff investor succeeded against one director who withheld material information, and who was found to be involved in the contravention of the company founding a *Corporations Act 2001* (Cth), s 1041I claim on the basis of being "knowingly concerned" (as defined in s 79) in the company's contravention of s 1041H(1). While a company can contravene s 1041H(1) without intent to mislead, for a person to be "knowingly concerned" in the company's contravention, that person must know that the conduct is made and is misleading and must intentionally participate or assist in the contravening conduct (*Giorgianni v The Queen* (1985) 156 CLR 473 at 494, 501). The mere fact a person is a director is insufficient (*Compaq Computer Australia Ltd v Merry* (1998) 157 ALR 1 at 4-5). Actual or constructive knowledge is required; a failure to inquire is not sufficient (*Giorganni v The Queen* (1985) 156 CLR 473 at 494, 501) unless knowledge can be inferred (*Pereira v Director of Public Prosecutions* (1988) 63 ALJR 1; 35 A Crim R 382).

²⁶ Court of Appeal held that McDougall J erred in finding dishonesty on the part of the director in respect of the December information where knowledge not dishonesty had been pleaded. *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* (2008) 73 NSWLR 653 at [69] (Hodgson JA).



investigation itself, the due diligence process itself can be pleaded as the misleading conduct. If materially misleading such that the disclosure of the truth would cause the issue to be cancelled or changed, then it may be regarded as causing an investor's loss without the need to prove actual reliance by the investor on the due diligence sign-off or due diligence process.

Where there is direct reliance by the investor on the misleading conduct, such as where the investor relies on the bank to structure a product compatible with its risk/return appetite, the structuring process itself may be pleaded as the misleading conduct. If materially misleading, such that the structuring of the product by the bank failed to take account of the investor's preferences, then such conduct may be regarded as causing the investor's loss.

The way the case is pleaded can determine its outcome. *Ingot Capital* opens the door to pleading due diligence committee process or proper investigations of processes rather than particular representations as the misleading conduct, in cases of both direct and indirect causation.

