

Property Fund News

February 2010

The proposed new MIS disclosure regulations—what do they mean for property fund managers?

Draft regulations

On 21 December 2009, the Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, released the draft regulations for the new managed investment scheme disclosure regime (Regulations).

We prepared an e-bulletin late last year setting out the key points from the Regulations. A copy of that e-bulletin can be found [here](#). The purpose of this article is to provide a more in-depth analysis of some of the more important issues flowing from the potential introduction of the Regulations.

Property fund managers not caught

The most significant point for property fund managers is that the Regulations, as they are currently drafted, will not apply to them. We have been saying for some time (and lobbying the government through Andrew Shearer-Smith's involvement on the Consumer Advisory Panel) that the Regulations would be inappropriate for a property fund; it seems the message may have got through.

The Regulations will only apply to product disclosure statements (PDSs) for registered managed investment schemes which invest at least 80 percent of their assets in "financial assets". Whilst the term "financial assets" is not defined in the *Corporations Act 2001*, "financial asset" is defined in pro forma 209 as part of ASIC's standard licensing conditions and if that definition is used, then property funds will not be caught; but property securities funds will be.

Investment decisions

It is encouraging to see that the Federal Government has turned its mind to the property fund sector when considering the Regulations. Unfortunately, the same cannot be said for the enhanced fee regulations when they were introduced some time ago. Whilst this recognition is a positive step for the property funds sector, it does raise the possibility of an uneven playing field between investment products caught by the Regulations and those that are not.

PDSs caught by the Regulations can be no more than six A4 pages in length (while a standard fixed-term property fund PDS can run for 80 pages). When potential investors are faced with reading a six page document or an 80 page document, this might sway their investment decision in favour of the product with the shorter PDS. Of course, this assumes that investors read any PDS provided to them, which the Federal Government's own research shows is questionable.

As property fund managers are not caught by the proposed Regulations, they should avoid the costs which will no doubt accompany the shift to the new disclosure regime. However, it will be interesting to see the effect (if any) on investment flows caused by the introduction of the Regulations.

Structuring issues

There may be some potential structuring implications caused by the Regulations applying to property securities funds but not to direct real property funds. For example, in the current economic climate it is not uncommon for fund managers who are looking to establish a new diversified fund to establish the fund with a small minimum subscription amount and make an initial investment in property securities.

This structure has its attractions; it gives the fund time to be established, the fund manager time to undertake a long capital raising campaign and talk to potential financiers and most importantly, secure a quality asset to seed the fund.

This structuring option may become less attractive with the introduction of the new Regulations. This is because whilst the fund invests over 80 percent of its assets in property securities, it will be caught by the Regulations and will require a six page PDS, including all of the prescribed content from the Regulations. However, once the fund manager finds an asset, they will then have to produce an entirely new PDS based on the current disclosure regime.

This will be a costly and time-consuming exercise and may impact on the fund's ability to move quickly on an opportunity.

Conclusions

The proposed Regulations, as they are currently drafted, definitely represent a positive for the property funds sector. It would be a very difficult process (if not impossible) to prepare a meaningful PDS for a property fund if it needed to comply with the Regulations. Furthermore, the exclusion of property funds from the operation of the Regulations will save the sector the considerable compliance costs and time that would need to be invested in shifting to a new disclosure regime.

However, by excluding some products from the regime, the Regulations create a two-tiered disclosure regime which has the potential to create a competitive advantage in favour of those products caught by the Regulations.

Nevertheless we assume the Federal Government will continue to investigate ways to improve disclosure to retail investors in all managed investment products so the property funds sector, given its exclusion at this point, is likely to be specifically targeted in the future.

We will continue to closely monitor this area and will report on any further developments.



If you would like more information, then please contact **Brendan Ivers** by email or on 07 3239 2928.

AUSTRAC surveillance—focus on AML/CTF independent reviews

Compliance assessments

In May 2009, McMahon Clarke Legal issued an AML/CTF e-bulletin, the purpose of which was to highlight the requirement under the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Act) for reporting entities to undertake regular independent reviews of ‘Part A’ of their AML/CTF programs.

At that time, we noted the Australian Transaction Reports and Analysis Centre (AUSTRAC) was likely to begin increasing its level of compliance assessments of reporting entities as part of its regular monitoring program.

This forecast has now come to fruition!

Towards the end of 2009, it appears AUSTRAC determined to enhance its AML/CTF assessment activity and many reporting entities will have already been subject to an AUSTRAC compliance assessment of their AML/CTF program. AUSTRAC says the objective of these assessments is to evaluate the policies, programs and processes which the reporting entity has implemented to meet its obligations under the Act.

Mandatory independent reviews

In our experience, a recurring finding of the AUSTRAC assessments to date is the failure of the reporting entities to have undertaken an independent review of ‘Part A’ of their AML/CTF programs. Given there is no prescribed timing under the legislation within which reviews must occur, only that they be undertaken “regularly”, this finding is perhaps not surprising. However, the results of AUSTRAC’s surveillance are a timely reminder to those reporting entities who have yet to arrange a ‘Part A’ independent review that AUSTRAC is closely monitoring compliance with this obligation.

With respect to conducting an independent review, reporting entities must determine whether the review can be conducted by an internal unit or whether an external independent reviewer is more appropriate. It is important the reporting entity is able to demonstrate the independence and quality of the review process.

Accordingly, an external reviewer will generally need to be engaged unless the reporting entity is able to employ the services of an internal auditing section (or another 'independent' area).

McMahon Clarke Legal can assist reporting entities meet their legislative requirements by conducting an independent 'Part A' review.

For more information regarding the independent review process or to discuss the independent review of 'Part A' of your AML/CTF program, please contact Langton Clarke or John Lane-Mullins.



Langton Clarke can be contacted by email or on 07 3239 2926.



John Lane-Mullins can be contacted by email or on 07 3239 2926.

Litigation news

Insolvent trading

The *Corporations Act 2001* (Act) imposes heavy penalties on directors who fail to prevent a company from trading whilst insolvent.

A director will breach his or her duty to avoid insolvent trading where—

1. the company incurs a debt and the company is insolvent at the time of incurring the debt or becomes insolvent as a result of incurring the debt, and
2. the director had reasonable grounds for suspecting, or did in fact suspect, that the company was insolvent, or would become insolvent.

Test for solvency

A company is insolvent when it cannot pay its debts as and when they become due and payable. This is not simply ascertained by looking at the bank account of the company but from considering the financial position of the company as a whole. The company's financial position includes—

1. the ability of the company to borrow on the security of its assets

2. the willingness of its secured creditor's to lend the company money despite its financial difficulties
3. the company's present unsecured borrowings and the possibility of further unsecured borrowings, and
4. any loans taken by related corporations and loans from directors of the company.

Conclusion

Where a company is wound up in insolvency, the Australian Securities and Investments Commission, the liquidator of the company or a creditor of the company may commence proceedings against the directors to recover loss or damage incurred as a result of the directors' contravention of the Act. Civil penalties of up to \$200,000 may also be imposed on the directors. Alternatively, directors may be subject to criminal charges which can result in a fine of up to \$220,000 or five years' imprisonment where there is a finding that the directors have acted dishonestly.

It is imperative that directors seek the advice of their accountants and legal advisors where it is suspected that a company of which they are a director may be insolvent. If no other remedial action is possible, then the directors might be well advised to appoint an administrator to the company to avoid further debts being incurred and to prevent personal liability attaching to them.



Allana Agnew can be contacted by email or on 07 3239 2947.

Changes to dividend rules—could company vehicles become more attractive?

Dividend reform

Proposed corporate law reforms, released at the end of last year, could end up having an interesting impact on property development fund structures.

The *Corporations Amendment (Corporate Reporting Reform) Bill 2010* contains a number of changes to the *Corporations Act 2001* (Act). One of them—replacement of the long-standing “profits” test for payment of company dividends—is quite significant.

The traditional rule, reflected in the current law, is that a company can only pay a dividend out of “profits”. However, changes in practice over time, particularly changes to accounting principles and policies, have made it increasingly difficult

for Boards to work out what “profits” are and whether a dividend can be paid. There is no definition of “profit” in the Act.

The amendment will replace the “profits” test with more flexible criteria, allowing a company to pay a dividend if the following tests are met:

1. The company’s assets exceed its liabilities and the excess is sufficient for the payment of a dividend.
2. The payment is fair and reasonable to the company’s shareholders as a whole.
3. The payment does not materially prejudice the company’s ability to pay its creditors.

The duty to prevent insolvent trading will not be affected.

How could this impact the property funds industry?

The unit trust has been (and continues to be) the most popular structure for property funds. Two main reasons for this have been the usual “flow-through” nature of a unit trust for tax purposes (including the ability to pass tax-deferred amounts through to investors), and the relative ease with which capital can be returned to investors. The need to comply with complicated share capital reduction provisions in the Act has meant that returning capital to shareholders in a company is normally an unattractive prospect.

However, most property development trusts with public investors are taxed as if they were companies anyway. The trusts are usually taxed “at the trustee level” and at the flat company rate. In reality, this has narrowed the differences between trusts and companies for use as development vehicles, from a tax perspective.

Now, it seems the proposed changes to the existing dividend rules will mean companies can include amounts of capital in dividend payments, apparently bypassing the normal capital reduction restrictions and procedures in the Act (in appropriate cases).

With more synergy between trusts and companies on the question of returning capital to investors, it is inevitable that fund managers will ask why they shouldn’t at least consider a corporate vehicle for a proposed development fund.

Corporate investment vehicles actually come with less regulatory burden than registered managed investment schemes—a company does not need a compliance plan, compliance committee or responsible entity (although, an appropriate financial services licence authorisation is needed to offer shares in an investment company).

Tax

Distributions by companies out of their profits are usually taxed as income, with associated franking credits. It will be interesting to see whether any changes are

needed to the existing tax law in relation to dividends which include some return of capital. For example, you would expect that franking credits should not be used to the extent a dividend (under the new rules) is paid from sources other than “profit”.

Conclusion

These dividend rule reforms will no doubt be welcomed by the business community, directors and accountants. However, it will have to be seen how the new tests will be interpreted and applied, particularly in relation to the inclusion of capital amounts in dividend payments.



If you would like more information, then please contact **Matthew Moses** by email or on 07 3239 2928.

Legislation to reverse Sons of Gwalia

Ranking of shareholders

The Government has announced a package of insolvency law reforms which includes proposed legislation to reverse the 2007 decision of the High Court in *Sons of Gwalia v Margaretic* (Sons of Gwalia). In that case, the High Court ruled that claims by aggrieved shareholders rank equally with those of unsecured creditors. The proposed change to the legislation will affirm the longstanding principle of the law; that shareholders rank behind creditors in a winding up.

CAMAC

In our March 2009 edition of *Property Funds News*, we reported on the review by the government’s Corporations and Markets Advisory Committee (CAMAC) and its recommendations. A copy of that article can be found [here](#). In their report, CAMAC found the decision of Sons of Gwalia should not be reversed, and noted the legislative intention to empower investors and require reporting and disclosure would be undermined if rights of recourse for aggrieved investors were curtailed. CAMAC considered aggrieved shareholders should be treated as creditors of the company, in a similar way to the position of unitholders of managed investment schemes who have a claim against the responsible entity.

However, the Government has stated the reasons for the proposed legislation include the uncertainty, cost and complexity of insolvency administration and the additional risk faced by debt providers.



If you would like more information, then please contact **Nicole Singer** by email or on 07 3239 2906.

Exoneration from breaches of director duties

James Hardie case

On 20 August 2009, Justice Gzell of the Supreme Court of New South Wales refused to exonerate three executive directors and seven non-executive directors of the James Hardie Group from liability from the court's ruling that they had breached their directors' duties.

In April 2009, Justice Gzell ruled that the directors of the James Hardie Group had breached the *Corporations Act 2001* (Act) by failing to exercise reasonable care and diligence in approving a draft ASX announcement (Announcement) containing misleading statements regarding the funding of the Medical Research and Compensation Foundation (Foundation) established by James Hardie Industries Ltd (JHIL). All but one of the directors sought to be excused from liability as a result of this decision.

The court may exonerate a director from liability where—

1. the person has acted honestly, and
2. having regard to all the circumstances, the person ought fairly to be excused for the contravention.

An act of honesty

With the exception of the CEO, the Australian Securities and Investments Commission did not allege that the directors had acted dishonestly. However, this is not indicative that the directors had acted honestly. Rather, the test for honesty is whether they had “acted without moral turpitude”. That is, whether they acted—

1. without deceit or conscious impropriety and without intent to gain improper benefit or advantage, and
2. without carelessness or imprudence at a level that negates the performance of the duty in question.

Excuse in all the circumstances

The second limb involves an examination of the following non-exhaustive factors:

1. The degree to which the conduct falls short of the statutory standard of care and diligence.
2. The presence or absence of contrition.
3. The seriousness of the contravention which is assessed by looking at—
 - (a) the importance of the provision contravened in terms of public policy
 - (b) the degree of flagrancy of the contravention, and
 - (c) the consequences to others caused by the contravention.

Findings

Justice Gzell refused to exonerate the directors, and made the following findings:

1. The directors had not acted honestly because—
 - (a) all the directors knew or should have known that the Announcement was too emphatic and unsubstantiated by the material available to JHIL. They all agreed they would not have approved the Announcement because it was phrased too emphatically
 - (b) not speaking against the approval of the Announcement was tantamount to approving it. This was inconsistent with a finding of honesty, and
 - (c) two of the directors had not requested a copy of the draft Announcement prior to the board meeting and failed to familiarise themselves with its wording. They had acted with carelessness and imprudence which was inconsistent with honesty.
2. The directors ought not be excused because of the seriousness and flagrant nature of the breaches. The Announcement was a key statement of the company with which they deliberately attempted to influence the market to achieve public acceptance of its restructure. Accordingly, Justice Gzell would not exercise his discretion under the second limb.

Attention to detail

This decision demonstrates the high level of attention and scrutiny courts expect all executive and non-executive directors to give to materials provided by management and their advisers, and its unwillingness to excuse those whose conduct falls below such expectations.

It is imperative that directors familiarise themselves with all matters and materials which have an impact on their decision making processes. The failure to do so can lead to the imposition of large penalties.



If you would like more information, then please contact **Allana Agnew** by email or on 07 3239 2947.

Employment law news

Did you know ...

From 1 January 2010, the balance of the new *Fair Work Act 2009* (Cth) (the Act) will come into force. The bulk of the Act came into force on 1 July 2009. However, introduction of the expanded list of minimum statutory employment conditions, known as the National Employment Standards, and modernisation of the award system was deferred until 1 January 2010.

Also from 1 January 2010, the Queensland and New South Wales Parliaments' referral of their powers to the federal government, relating to industrial relations for the private sector, will take effect with the result that sole trader and partnership employers in those States will now be governed by the Act.

Previously, the federal government's power to legislate was limited to national system employers (largely companies incorporated under the *Corporations Act 2001* and all employers in NT and ACT) which meant that important provisions of the Act would not apply to most private sector employers such a sole traders and partnerships.

All States except Western Australia (who has refused) have now passed legislation referring their powers to the federal government.

Contact

If you would like some advice as to how the Act will affect your business, or assistance in updating your procedures, then please contact Kristy Dorney, an associate in our litigation and risk management team.



Kristy Dorney can be contacted by email or on 07 3239 2968.

The One.Tel decision—important directors' duty update

ASIC fails to prove its case

Justice Austin in the Supreme Court of New South Wales handed down judgement on 18 November 2009 in the case brought by the Australian Securities and Investments Commission (ASIC) against Jodee Rich and Mark Silbermann. The action was commenced in December 2001, shortly after the collapse of One.Tel. ASIC's case was that Mr Rich and Mr Silbermann misled the One.Tel board (which included James Packer and Lachlan Murdoch) about the financial state of the company.

Whilst One.Tel was a listed entity, its major shareholders were Kerry Packer's Publishing & Broadcasting Limited and Rupert Murdoch's News Corporation. Both of those entities lost huge sums in the One.Tel collapse. The question which Justice Austin had to determine was whether or not the executive directors had failed to keep the board informed of the company's financial position. He did not have to determine whether or not the other directors on the board were careless in failing to find out the truth about their company's position, although that issue might arise in other litigation currently on foot.

Waste of time?

Some commentators have pointed out that the case is a lesson for ASIC in how not to run litigation. The case ran for eight years and is reported to have cost ASIC \$20 million in legal fees. If ASIC is ordered to pay the costs of the defendants, then the case could cost ASIC up to \$40 million in total. This is particularly significant when considered in light of ASIC's overall annual budget of about \$300 million. There is no doubt that the case has chewed up an enormous amount of resources and diverted attention away from other routine compliance and enforcement activities.

However, the case will be of great interest to anyone involved in the management of companies. Justice Austin is an acknowledged authority on directors' duties, and he has written his judgement in a way which will be of assistance to a wide audience outside of the One.Tel mishap. The judgement is 3,105 pages long but is conveniently broken up into chapters. Anyone wanting to focus on the important findings regarding directors' duties should read chapter 23 which starts at page 2,942.

We have summarised some of the findings from the case, but for a more comprehensive coverage of the case, please go to our full length article [here](#).

Directors should take note that this represents the current state of the law in Australia and their performance will be judged against these principles.

Duty of care and diligence

1. Justice Austin noted that the *Corporations Act 2001* (Act) did not intend to dampen business enterprise and penalise legitimate but unsuccessful

entrepreneurial activities. Accordingly, the question whether a director had exercised a reasonable degree of care and diligence for the purposes of the Act could only be answered by balancing the foreseeable risk of harm against the potential benefits that could reasonably have been expected to accrue to the company from the conduct in question.

2. In assessing what a reasonable person would do in the position of the director in response to a given risk, the court needs to consider the magnitude of the risk and the degree of the probability of its occurrence, along with the expense, difficulty and inconvenience of taking alleviating action and any other conflicting responsibilities the director may have. In considering the cost of alleviating action, Justice Austin accepted a submission put to him by Mr Rich and Mr Silbermann that the court should avoid a finding that certain information not contained in board papers should have been there where the consequences may be that board papers would grow to the size of a telephone book.
3. The statutory standard of care and diligence for company directors recognises the distinction between negligence and mere mistakes. In particular in the One.Tel case, the complaints made by ASIC were about financial forecasting. Justice Austin noted that forecasting is a difficult and uncertain process, with much room for mistakes and errors of judgement, and for differences of opinion. The directors could not be liable just because they made mistakes in the processing of financial forecasting or because they formed a different opinion to ASIC or the court.

Business judgement rule

1. In considering what constitutes a business judgement, Justice Austin approved U.S. commentary to the effect that it doesn't just encompass risky or economic decisions, but also applies to decisions relating to corporate personnel, the termination of litigation and other less explicit business decisions. It could embrace decisions including the setting of policy goals and the apportionment of responsibilities between the board and senior management. Justice Austin also considered that it would include matters of planning, budgeting and forecasting.
2. However, he noted that under the Act, it must involve "*a decision to take or not take action*". This means that a decision must consciously be made so that the judgement has actually been exercised. A director who simply neglected to deal with proper safeguards, with no evidence that he or she even turned his or her mind to a judgement of what safeguards there should be, has not made a business judgement and accordingly, cannot invoke the defence.
3. In One.Tel, ASIC claimed that Mr Rich and Mr Silbermann had artificially attempted to treat what was, in substance, inaction or omissions on their part as conscious and considered acts involving the exercise of judgement. Justice Austin did not accept that submission. He accepted evidence from Mr Rich and Mr Silbermann that they made decisions about the matters of which ASIC complained. It was not a case where the directors had failed to

turn their minds to decisions that ASIC alleges they should have taken. The directors considered the matters of which ASIC complained, but made decisions with which ASIC disagreed. In essence, this is why ASIC's action failed.

Conclusion

The reasoning and conclusions in this case are compelling reading for anyone involved in the management of a company. Justice Austin has articulated the principles relevant to assessing the performance of a director in a way that should be readily understandable to company directors and officers.

McMahon Clarke Legal can assist you with any queries regarding directors' liability and obligations.



If you would like more information, then please contact **Sarah Davies** by email or on 07 3239 2960.

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