

financial services newsletter

Regulation and Compliance

Information contained in this newsletter is current as at March 2006

Making sense of Westpoint

June Smith ARGYLE LAWYERS

The collapse of the Westpoint group of companies will have wide ramifications over a number of years to come for many industries, including the financial services industry.

This article outlines the action taken against Westpoint to date and the case that is likely to be made against the financial planners who advised clients to invest in Westpoint property projects across Australia via mezzanine financing companies and promissory notes.

What is mezzanine financing?

Mezzanine financing is frequently used in property transactions and construction, infrastructure funding and finance structures for mining and resource projects. Mirvac¹ estimates that in 2005, the level of mezzanine debt lending in Australia for property construction alone was around \$1.5 to \$2 billion, or 5 per cent of the total construction lending market.

Mezzanine financing usually occupies a position between the first mortgage held by banks and other lenders on a project (which may make up from 60 to 80 per cent of total development costs) and equity investors (around 10 per cent of the total development costs) who have very high levels of risk, but who can be compensated by generous dividends, capital growth or both if the project is a success.

Mezzanine debt is attractive to some investors because of the relatively high yields available on capital to compensate for the risks involved (which can be substantial depending on the project). It is sometimes referred to as a second mortgage and usually comprises 10 to 20 per cent of total

development costs of a project, with typical interest rates of 13 to 20 per cent return paid to investors. In the event that a project fails, these investors rank behind the first mortgagee but ahead of equity investors in terms of claims on assets. It should be recognised, however, that property development and construction are intrinsically high risk and the downside can be a total loss of principal if the project is unsuccessful.

What action is being taken?

Since November 2005, the Australian Securities and Investments Commission (ASIC) has commenced 25 proceedings against companies in the Westpoint group, 10 of which have concluded. Further, six different liquidators have been appointed by courts and creditors to over 17 group companies. The property investment schemes operated by those companies include:²

- Emu Brewery Mezzanine Pty Ltd;
- York Street Mezzanine Pty Ltd in Sydney;
- North Sydney Finance Ltd;
- Anne Street Mezzanine Pty Ltd in Brisbane;
- Bayshore Mezzanine Pty Ltd, Bayshore Port Melbourne Pty Ltd, Bayview Heritage Mezzanine Pty Ltd and Market Streets Mezzanine Nos 1 and 2 in Melbourne;
- 297 Murray Street Trust;
- The Warnbro Fair Syndicate;
- The Westpoint Income Fund;
- Mount Street Mezzanine Pty Ltd;
- Paragon Commercial Syndicate; and
- The Scots Church development.

Investors' money will remain tied up in the schemes pending the

determinations of liquidators on the sale of assets held by the group.

The Federal Court in Perth has ordered the winding up of Westpoint Corporation Pty Ltd for insolvency.³ It is this company that ASIC alleges arranged, managed and co-ordinated Westpoint property projects, in addition to holding money for other group companies. It is also alleged that Westpoint Corporation is one of the guarantors for loans advanced by the various Westpoint mezzanine companies to developer companies for the property development projects undertaken by the Westpoint Group. The company has not been able to make good expected shortfalls owed to investors.

ASIC commenced proceedings against Emu Brewery Mezzanine Ltd in May 2004 as a test case, arguing that the promissory notes issued by Westpoint schemes needed to comply with the disclosure provisions of the *Corporations Act 2001* (Cth) relating to debentures. In the alternative, ASIC argued the promissory notes created interests in a managed investment scheme.

In November 2004, the Western Australian Supreme Court decided that the promissory notes were not financial products (debentures) but that they constituted an interest in a managed investment scheme. Both ASIC and Westpoint have appealed and a decision is pending from the WA Court of Appeal. The decision will identify the extent to which ASIC has jurisdiction over the investments offered by Westpoint and what other actions ASIC can pursue against the Westpoint companies and directors.

However, the decision should have little impact on ASIC's ability to take action against licensed financial advisers operating under the *Corporations Act* in the provision of advice to clients.

The case against financial planners

While not all investors were introduced to Westpoint by financial planners (many were introduced via mortgage brokers, promoters and unlicensed advisers), it seems likely that financial planners will bear the brunt of attempts to compensate investors for losses incurred and will

be subject to regulatory action to be undertaken by ASIC and no doubt increased surveillance activities by the regulator as well. This is because the significant majority are licensed or authorised to give advice on behalf of an Australian financial services licensee under the *Corporations Act* and, in addition, carry professional indemnity insurance.

Law firm Slater and Gordon is considering a class action on behalf of some 2000 investors against up to 100 financial planning firms that recommended investment in the mezzanine financing schemes associated with Westpoint.⁴ The action is likely to seek over \$200 million.

Many of the investors were self-funded retirees who invested their superannuation savings with Westpoint. Some investors also claim they were encouraged to borrow against their homes in order to make the minimum investment, which for most Westpoint promissory notes was \$50,000.⁵

It would seem, therefore, that in addition to questions of whether or not financial planners breached their legal obligations to investors under the *Corporations Act*, there may also be questions of the common law duty of care that should have been extended to investors who were encouraged to invest their life savings in Westpoint, and whether or not it was prudent to advise other clients to gear or borrow to invest, which would have meant additional risk for the client.

While the class action is also likely to target directors and promoters of the schemes, allegations likely to be raised against the financial planners include:⁶

- a failure to ensure clients understood the nature of the investments and the risks involved;
- advising clients that the 'promissory note' was capital guaranteed and secured against specific property projects (when it was not);
- failure to disclose commissions of 10 to 12 per cent for recommending Westpoint schemes (instead of the typical 2 per cent); and
- presenting the investments as low risk.

Fundamental industry and legal standards will apply to the conduct that should have been exhibited by financial planners in the circumstances,

irrespective of whether the advice to invest was given pre- or post the commencement of the financial services reform (FSR) regime. Some of these standards, currently found in ss 945A to 947B of the *Corporations Act*, include the obligation to:

- know the client;
- know the product;
- assess the suitability of the investment to the client's needs;
- disclose the risks associated with mezzanine financing and the particular schemes invested in;
- assess the client's tolerance to that risk; and
- disclose fees and commissions received by the planner in relation to the investments and any conflicts of interest that may have applied.

Some initial questions arise in relation to the application of these standards which will need to be answered.

- How did the financial planners select clients to invest in the scheme?
- Did the financial planners give clear advice on the nature of the investment?
- Were clients advised that the investment was in the form of a promissory note?
- Did clients understand they were investing in mezzanine finance or something else?
- Were clients told the investment was secured and capital guaranteed?

In their defence, some financial planners have alleged that they were duped by Westpoint over the nature of the guarantees given by the company about investments in the schemes.⁷ It will be interesting to see whether planners will also allege they were unaware that investors' money was pooled and used by Westpoint for various purposes of the group, instead of going to individual property development projects, as is currently alleged by ASIC.

Other issues that are likely to be important include the following.

- Were clients advised of the commission and fee structure associated with the investment?
- Were conflicts of interest in relation to the investment managed effectively by the licensee (only for advice given under the current *Corporations Act*)?

- What, if any, alternative remuneration was paid as a result of the investments and was that disclosed?
- Were clients informed about the risk and the risk/reward trade-offs usually associated with such investments?
- How did advisers determine the percentage amount clients had to invest in this venture?
- Did advisers switch clients out of other investments inappropriately to invest in Westpoint (the current s 947D of the *Corporations Act*)?
- What research went into placing Westpoint investments onto approved lists?
- What ongoing review of the investment was done by the licensees and the advisers, given allegations that only one 'independent' research house reviewed Westpoint products favourably and it advised in 2004 of significant delays on two property projects; that Westpoint was in litigation; and that there was a lack of

available audited financial statements?

The repercussions — what can we expect?

Whether or not the class action against financial planners is ultimately upheld, the fallout across the industry and the pressure on FSR is likely to be enormous. There is also the distinct possibility that some advisers and licensees will be banned from the industry altogether, and upward pressure on professional indemnity insurance premiums is likely.

It is also likely to be a testing time for both the self-regulatory capabilities of professional associations, such as the Financial Planning Association of Australia, and the new industry standards on conflicts of interest and remuneration structures which it released on 2 March 2006.

Stay tuned for what could be a very bumpy ride. ●



June Smith,
financial services industry
consultant and
Partner, Argyle Lawyers,
<jsmith@argylelawyers.com.au>.

Endnotes

1. *Mezzanine Debt and Property Investment — Understanding and Managing the Risk/Return Trade Off*. Mirvac, January 2006 p 3.
2. 'Westpoint investors meeting' ASIC, 23 February 2006.
3. 'Federal Court orders winding up of Westpoint Corporation' ASIC Media Release, 17 February 2006,
4. 'Law suit targets financial planners' *The Australian* 23 February 2006.
5. 'Into the void' *The Sydney Morning Herald* 28 February 2006.
6. 'Fed: angry investors launch \$200m law suit' CCH 22 February 2006.
7. Above note 5 at p 2.