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Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in Liq) [2012] FCA 1028

'The nature and risks of a SCDO (Synthetic Collateralised Debt Obligation) are concepts that are beyond the grasp of most people ... Nonetheless, Grange (Securities Limited) portrayed itself as an expert in these investments. Most certainly, none of the seven council officers who gave evidence had any expertise in these financial products. Grange knew and preyed on that lack of expertise and the trust the councils placed in its expert advice' (Justice Rares at 410).

Introduction

During April and May 2008, Paul Buitendag (Head of Reconstruction & Insolvency at Cornwall Stodart) and external consultant and forensic accountant David Collett, delivered a presentation predicting the potential effects of the developing Global Financial Crisis (**GFC**) and how it would impact Australia.

The warnings

We warned about:

- the impending GFC and the potential effect on the stock markets and the value of other assets
- the potential exposure to losses through investments in Collateralised Debt Obligations (**CDOs**) and Credit Default Swaps (**CDSs**)
- investors questioning financial advisors who put them into funds that were paralysed, and locked their savings into highly leveraged, illiquid and risky investment portfolios
- pressure being exerted on directors and auditors for fair value accounting standards
- the most challenging issues we might all face in the near future being those of misrepresentation, duty of care and contractual obligations
- the exposure to potential litigation, as lawsuits relating to the GFC, would increase substantially.

We also demonstrated how investors would target financial institutions, advisors, executives and even ratings agencies in order

to obtain compensation for the losses faced by investing in CDOs and CDSs.

In September 2008, Cornwall Stodart delivered a follow up presentation because many of the warnings given in April 2008 had become a reality. We again warned that many local city councils, charities and not for profit organisations, churches and superannuation funds were exposed to losses from sophisticated investment instruments including CDOs and CDSs, and they would begin to look at who was responsible in an effort to recoup losses suffered. We warned of the risk of possible claims against financial institutions, advisors, executives and ratings agencies for misrepresentation, duty of care and contractual obligations.

The warnings realised

At the time of our October 2010 presentation, the exposure of financial institutions, advisors, executives and ratings agencies to potential litigation from public and private sector organisations and individuals for losses incurred through investment in CDOs was clear. Allegations of lack of disclosure are being supplemented by allegations of misleading advice and conduct, professional negligence, breach of fiduciary duty, misrepresentation, duty of care and contractual obligations. Proceedings had been commenced against financial institutions by private investors, shareholders and local city councils including proceedings issued by Wingecarribee Shire Council against Lehman Brothers Australia Ltd.

On 21 September 2012, our Justice Steven Rares of the Federal Court delivered a landmark decision, paving the way for further proceedings against financial institutions, advisors, executives and ratings agencies when he found in favour of the applicant councils in *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in Liq)* [2012] FCA 1028 (**Lehman Decision**). Justice Rares found that the respondent, Lehman Brothers Australia (formerly Grange Securities Ltd (**Grange**)), 'is liable to the councils for their claims in contract, in negligence, for misleading and deceptive conduct, as well as for breach of fiduciary duty' [984]. Further:

> 'The contrast between the actual, and patent, lack of financial acumen of the various Council officers at each of Swan, Parkes and Wingecarribee and the intelligent, shrewd and financially astute persons at Grange was striking.' [752]. 'Generally, risk-averse people do not take bets with substantial assets held for public purposes' [895].

Background to the proceedings

The claim

Lehman Brothers involved a representative action comprising three applicants: Wingecarribee Shire Council (**Wingecarribee**), Parkes Shire Council (**Parkes**) and the City of Swan (**Swan**) (collectively **Councils**) on behalf of 72 Australian councils, charities, church groups and private investors who lost $248 million on their investments during the GFC. The Councils made a claim for damages, equitable compensation and an account of profits arising from any or all of the following:

- negligent misstatement;
- breach of fiduciary duty;
- breach of contract (arising from 'Individual Managed Portfolios'); and
- misleading or deceptive conduct (section 1041 of the *Corporations Act 2001* (Cth) for a 'financial product or financial service' or section 12DA(1) of the *Australian Securities and Investments Commission Act 2001* (Cth) (**ASIC Act**) for 'financial services').

This was because the Councils contended that:

1. the SCDOs were either illiquid, in that there was no active or assured secondary market in them or they were materially less liquid than FRNs with an equivalent rating;
2. the SCDOs had the risk of market price volatility. The Councils argued this was because the price for which they

could be realised depended on Grange being able to make a secondary market in, or itself buy back, a SCDO if a Council wanted to sell it before maturity;

3. the SCDOs were not equivalent, as regards material risks, to other types of financial products carrying the same ratings because the rating assigned to each SCDO only addressed the probability of default and did not address:
   a. the market implied risk in the SCDO itself;
   b. the amount of loss in the event of default.

Relevant facts

Between 2003 and 2008, representatives of each of the Councils sought advice from Grange Securities Ltd (a wholly owned subsidiary of Lehman Brothers Inc following its acquisition in March 2007) regarding the availability of 'conservative, risk averse investments' that complied with the Councils' legislative and policy restraints concerning investment (eg securities required to have an A1 rating): [1002]. The Councils' officers were found to be 'financially unsophisticated' investors: [268]. Grange represented itself as a financial adviser who understood the Councils' investment requirements.

Each of the applicants subsequently acquired financial products (underwritten by Grange) that included 'Synthetic Collateralised Debt Obligations' (SCDOs). The SCDOs were highly rated: between AAA and AA- at the time of their issue. The SCDOs operated in a similar fashion to CDOs but provided a return or loss based on the accurateness of the holder's predictions regarding the occurrence of 'credit events'. The various credit events included rating downgrades or defaults on the loans that underpinned the SCDOs.

As a consequence of the economic downturn linked to the GFC, many of the SCDOs suffered credit events in 2007. The capital invested in three SCDOs was wiped out completely and 11 SCDOs were quarantined pending the resolution of litigation associated with the liquidation of the US subsidiaries of Lehman Brothers Holdings Inc.

On 26 September 2008 administrators were appointed to Lehman Australia. Based on recommendations made by the administrators, the majority of creditors of Lehman Australia passed a resolution that Lehman Australia execute a Deed of Company Arrangement (**DOCA**).

On 12 June 2009 the DOCA was executed. The effect of the DOCA was (relevantly):

- to release not only Lehman Australia but also all other Lehman entities from all claims that any creditors of Lehman Australia may have against them; and
- to preclude creditors from pursuing insurance claims against the insurers of Lehman Australia and other Lehman entities.

Earlier proceedings

On 25 September 2009 the Federal Court found that the DOCA was void and of no effect and ordered that Lehman Australia be wound up. The court agreed that the DOCA purported to extinguish the Councils' rights to sue other Lehman entities and, in doing so, went beyond the scope permitted by Part 5.3A.

In March 2010, the High Court of Australia dismissed an appeal by LBA against a decision of the Federal Court, paving the way for investors to make claims to recover $600 million in losses. The High Court upheld the Federal Court's 2009 decision that found a DOCA, which was approved by creditors of LBA, as being void and with no effect. Had the DOCA been upheld, the Council and other investors would have received between 2.4 cents and 10 cents in the dollar for failed investments, while related LBA companies could have received all their money back. Under the DOCA, the councils would have been forbidden from taking any further legal action against LBA or associated companies.

In July 2010, the two sides agreed to enter mediation overseen by the Federal Court over the next six months, giving councils and Lehman's liquidators a chance to come to a compromise. Since the parties failed to reach a settlement, Wingecarribee Council had leave to proceed with a class action against the failed investment house.

The findings

Fiduciary duties

Rares J found that Grange existed in a fiduciary relationship with the Councils irrespective of the presence or absence of an Individual Managed Portfolio agreement (**IMP**) between the parties. As a consequence, the following two (usual) proscriptive fiduciary

duties were owed by Grange independent of any IMP:

- a duty not to obtain any unauthorised benefit from its relationship with the Councils; and
- a duty not to be in a position where its interests conflicted with the interests of its fiduciary: [932].

The Councils claimed that the abovementioned duties were breached by the following:

- Grange's substantial and undisclosed fees or profits that were remitted in connection with the underwriting, structuring and selling of the SCDOs; and
- Grange's conduct in buying/selling SCDOs as purchaser/ vendor in transactions with the Councils.

Specifically, Grange owed a duty to give sound financial advice to the Councils and to make investment choices on behalf of the Councils that were in their best interests. However, while being required to adhere to these duties, Grange was also attempting to act **in its own interests by earning large fees or profits** from every sale of SCDOs (typically deriving 1-2 million for each new issue). Grange also **controlled the secondary market** on which the SCDOs were sold and accordingly set the prices at which the securities were bought and sold. Grange **also entered into 'repurchase agreements' that were effectively loan transactions** with the Councils (Grange as borrower), which offered an interest rate at BBSW + 0.1% (a rate below that offered on a bank issued floating rate note).

An internal email (dated 10 November 2006) written by Moray Vincent, Grange's director of debt capital markets, to Richard Portlock, Grange's Perth based director, highlighted the problems Grange was suffering in having to fund the promises it had made to its clients that it would provide a secondary market and liquidity, saying:

> 'The situation is analogous to our no haircut repos with Councils. In reality although these guys have no haircut, they have the defence that if we don't buy the stock back from them that we knowingly took advantage of them and they would have a case against our deep-pocketed Directors. If we did repos with haircuts, this case of being uninformed would be severely weakened as the haircut is defacto an acknowledgement of the risk of price movement and counterparty being caught short with Grange going bust and the stock post haircut being worth less than their investment. However obviously the informed institution makes the haricut [sic] so large that is [sic] covers their "mpl" [scil: maximum potential loss] scenario that makes funding stock with informed investors prohibitive for us.' (emphasis added)

In other words, Mr Vincent and Grange were well aware that an informed client would never lend on the basis of the 'no haircut repos' ('repo' being an abbreviation for 'repurchase transaction'), but would demand significantly more security to reflect the risk. If Grange were to have advised the Councils of this, as it had to if it were a fiduciary, they would have been made aware that the SCDOs were risky, illiquid and if sold might realise far less than their face value: ie the very kinds of risk factors highlighted by the issuers' documentation [267].

Having found that Grange owed fiduciary duties to the Councils, which would have been breached by the conduct outlined above, his Honour proceeded to focus on whether Grange (who carried the onus of proof) had obtained the Councils' informed consent for Grange to act in non-compliance of its duties.

His Honour held that Grange did not obtain the informed consent of any of the Councils, relying on the following:

- Grange 'never squarely addressed with [the Councils] how it benefitted from the proposed transactions': [933];
- disclosure in the contract notes that Grange was either a buyer or seller (and the subsequent acceptance of the contracts) was not sufficient to constitute informed consent:

[934]; and

- lack of disclosure regarding fees, or profits that it stood to earn from selling any new or other SCDO to the Councils: [936].

With regard to the amount of detail that is required to constitute adequate disclosure, his Honour cited *Gray v New Augarita Porcupine Mines Ltd* [1952] 3 DLR 1 at [14]:

> 'There is no precise formula that will determine the extent of detail that is called for when a director declares his interest or the nature of his interest ... The amount of detail required must depend in each case upon the **nature of the contract or arrangement proposed and the context in which it arises** ... if it is material to [the matter] they should know not merely that he has an interest, **but what it is and how far it goes**, then he must see to it that they are informed.'

His Honour held that the Councils knew of the existence of an interest held by Grange, but they were not made aware of the nature or extent of that interest and therefore at no point did they provide their **informed consent** to the dispensation of Grange's fiduciary duties: [939].

Rares J then considered the effect, if any, of the IMPs that Grange entered into with Wingecarribee and Swan in January 2007 and February 2007 respectively. His Honour concluded that Grange continued to owe fiduciary duties to the Councils that were unaffected by the IMPs. Importantly, his Honour noted that **even if he was wrong** about whether or not Grange owed fiduciary duties to its clients independently of the IMPs, the IMPs gave rise to a relationship of **agency** between Grange and the Councils. Grange owed fiduciary duties to the Councils thereafter by virtue of this established category of fiduciary relationship.

Individual Managed Portfolio agreements

Grange entered into IMPs (drafted by Grange) with two of the Councils that authorised Grange to decide upon and invest in a range of financial products subject to conditions.

Wingecarribee entered into an IMP in January 2007 that provided Grange with the authority to invest its monies subject to:

- compliance with the Council's investment guidelines (risk averse, capital preservation); and
- a right of the Council to require Grange to remove any investment at 'market price'.

While the Council's investment guidelines permitted Grange to invest in CDOs and 'structured products', they also required any investment to be a product for which there was an 'active secondary market': [812]. The guidelines prohibited investment in derivatives.

Swan's IMP agreement required that the Council have 'ready access' to the funds without penalty: [904].

His Honour found that Grange was in breach of its IMPs with both Wingecarribee and Swan because 'it was negligent to use public money in investments with the risks that I have found the SCDOs had'. In addition, Grange breached the Swan IMP agreement because the SCDOs did not provide that Council with ready access to funds, due to their lack of liquidity. It also breached the Wingecarribee IMP agreement because the SCDOs had no active secondary market and were derivatives.

Grange claimed indemnity under the IMP agreements. It argued that clause 8 of the IMP agreements with each of Swan and Wingecarribee contained a contractual indemnity in its favour. The clause required the Council to indemnify Grange against any claim, loss, action, demand, damages and liability '... suffered or incurred by Grange directly or indirectly in connection with ... (c) anything lawfully done by Grange under this agreement'. Grange contended that this indemnity applied to its investment in the SCDOs on behalf of each of Swan and Wingecarribee under their IMP agreements and claimed the right to set off the indemnity against any damages awarded to either Council [980].

His Honour stated that, since he had found that Grange acted in breach of each IMP agreement:

> 'Its conduct in so acting was not "lawfully done under" either IMP agreement within the meaning of clause 8. That is because Grange was not authorised by the Councils to act as it did, under the IMP agreement. A party's breach of a contract is not an act done under the contract but rather it is an act done contrary to, and in violation of, its terms. The indemnity in clause 8 did not protect Grange from the consequences of its own breach' [981].

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Negligent misstatement

Rares J found that Grange negligently advised the Councils regarding the suitability of the SCDOs given:

- the lack of high-level security for the invested capital; and
- their lack of liquidity.

His Honour also found that Grange's acts in investing in the SCDOs were negligent under the terms of the IMP due to the inappropriateness of using public monies to invest in products involving the risks carried by the SCDOs.

Misleading or deceptive conduct

For the reasons described above, Rares J held that Grange engaged in misleading **and** deceptive conduct. His Honour also held that the following were misleading and/or deceptive:

- the description of the SCDOs' credit rating as being in the same 'universe' as AAA rated Australian government loans and AA- loans to large banks: [246], [279];
- Granges' representations that SCDOs presented as a capital protective investment suitable for a conservative investment strategy; and
- representations that the SCDOs complied with the Councils' policies.

Notwithstanding the high credit rating of the SCDOs, his Honour stated that due to the synthetic nature of SCDOs, they were susceptible to systemic market events (eg large market correction, rescission or as was the case here, the GFC) and were therefore dissimilar to similarly rated products: [95].

Contributory negligence

Grange attempted to off-set a portion of its liability (50%) by asserting that the Councils were contributorily negligent and were therefore subject to the proportionate liability provisions contained in section 12GR of the ASIC Act.

Grange claimed that **Swan** failed to act reasonably because its officers:

- failed to understand the documents provided by Grange that concerned the nature and risks of SCDOs;
- did not read the documents provided or did not pay sufficient attention to the documents;
- failed to inform Grange that investments in the SCDOs did not comply with Swan's investment preferences; and
- failed to ensure the investments complied with Swan's 2003 investment policy: [1132].

In finding that **Parkes** was not contributorily negligent, Rares J held:

> 'The mere fact that Swan's officers were made aware of certain risks cannot be divorced from the context of Grange being its financial adviser [1137]... If a professional recommends or advises a client to take, or takes on the client's behalf, a particular step or decision based on the professional's expertise, ordinarily the client will not be equipped to analyse, and certainly not with the same degree of expertise, the basis on which the recommendation or advice was given or the step or decision taken' [1138].

Grange claimed **Parkes** failed to act reasonably principally because it delegated responsibility for investing its surplus funds to an officer who was not suitably qualified to perform the required tasks: [1143]. In finding that Parkes was not contributorily negligent, Rares J held:

> 'I am of opinion that it is just and equitable to require Grange to bear all the damages despite any faults of Parkes. Grange was the expert adviser. It set about selling, for significant profit to itself, products that were not suitable for its risk averse client, Parkes. Grange selected what it told and did not tell Parkes. It knew that Parkes, and other local government councils, were completely at sea with SCDOs and exploited that ignorance for its own benefit' [1168].

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Grange claimed that Wingecarribee failed to act reasonably because it failed to amend the permitted investments in the IMP to remove CDOs. In the context of Wingecarribee previously expressly informing Grange that it did not wish to invest in SCDOs, Grange argued that on the execution of the IMP:

> 'it was clearly in Wingecarribee's own hands to give express instructions to Grange that only the [pre]existing range of investments should be permitted': [1172].

Rares J stated:

> 'Grange's conduct was such that it would be an affront to notions of what is just and equitable to reduce Wingecarribee's damages at all. Essentially, this argument is that Wingecarribee should not have trusted Grange to do what it had been asked to do and said it would do. Wingecarribee acted reasonably in trusting Grange' [1174].

His Honour rejected the partial defence in respect of all three Councils for reasons specific to each of them.

Maintenance of a secondary market for brokered financial products

Grange made representations (verbal and written) that the SCDOs would be tradable on a secondary market and would usually be sold quickly and at or above face value. Grange provided and controlled the secondary market for the sale and purchase of SCDOs. Grange frequently purchased the SCDOs and on-sold these to other clients at a premium. Grange made large profits from trading in the secondary SCDO market.

Following the effects of the GFC – which were compounded by Grange's undercapitalisation – Grange ceased to operate the secondary market, leaving the Councils holding SCDOs that they were forced to retain until their maturity because of their illiquidity.

Grange only once informed its investors that its secondary market may cease to operate in response to systemic market conditions. This was done using fine print in a PowerPoint Presentation in April 2011.

Remedy

As outlined above, Rares J found that Grange made negligent misstatements, beached the terms of IMPs and engaged in misleading and/or deceptive conduct. However, in light of the liquidation of Lehman Brothers, his Honour granted the parties additional time to consider the judgment in detail prior to proposing draft final orders.

As a preliminary indication, his Honour stated that the Councils would be entitled to damages/compensation equal to:

- the loss arising from those SCDOs that paid less than 100 cents in the dollar on maturity or that the Councils sold at a loss pursuant to a strategy of mitigation;
- the difference between 'par values' and the values of the unmatured SCDOs; and
- the value of the SCDOs that are presently quarantined as a consequence of legal proceedings in the UK and USA.

What it means for you

Prior to delivering judgment, Justice Steven Rares said:

> 'How was it that relatively unsophisticated council officers came to invest many millions of ratepayers' funds in these specialised financial instruments? That is the fundamental question at the heart of these proceedings' (at 14).

This question is likely to resonate with many investors who have been pondering why their financial advisors put them into funds that are, at best, paralysed – and many of them locked into highly leveraged, illiquid and risky investment portfolios. Following the Lehman Decision, investors now have a precedent to look to financial institutions, advisors, executives and even ratings agencies for compensation of losses arising out of the decision.

- **Have you or your firm or organisation made negligent misstatements or fallen victim to negligent misstatements?**
- **Have you or your firm or organisation made proper disclosure?**
- **Have you fallen victim to misleading and deceptive conduct?**

With regard to fiduciary duties, those persons issuing advice regarding financial products should be aware that they may breach their fiduciary obligations by:

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a. operating or otherwise controlling a secondary market for a class of securities that are recommended to the client by the adviser; and
b. failing to disclose the particulars of any fee, profit or benefit that is derived by the adviser as a consequence of investment by the client in a particular financial product.

This decision will not be the last. A class action led by Maurice Blackburn against the National Australia Bank (**NAB**) began in November 2010, claiming losses on behalf of investors in relation to CDOs.

In 2006, NAB had bought $1.2 billion in CDOs that comprised asset-backed securities, with a heavy exposure to the US subprime mortgage market. In May 2008, NAB was forced to write-down the value of the parcel of collateralised debt obligations by $181 million, followed by a second write-down of $830 million in July 2008.

On 24 August 2012, the Supreme Court of Victoria ordered the publication of notices in national newspapers to open the class action to all investors who held shares in NAB between 1 January and 25 July 2008. The court also directed NAB to write to 230,000 shareholders, advising them of the opportunity to join the class action. Over two-hundred and fifty institutional and retail investors are currently members of the class action. The matter is scheduled for trial in December 2012.

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For more information or to discuss how this decision and the NAB class action may affect you, your firm or your organisation, please contact:

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