

IN THE HIGH COURT OF NEW ZEALAND
WELLINGTON REGISTRY

CIV No. 2008-409-348

BETWEEN E M HOUGHTON

Plaintiff

A N D T E C SAUNDERS & Ors

First Defendants

A N D CREDIT SUISSE PRIVATE EQUITY INC

Second Defendant

**A N D CREDIT SUISSE FIRST BOSTON ASIAN MERCHANT PARTNERS
LP**

Third Defendant

A N D FIRST NZ CAPITAL

Fourth Defendant

A N D FORYSTH BARR LIMITED

Fifth Defendant

PLAINTIFF'S CLOSING SUBMISSIONS

Date: 3 June 2014
Judicial Officer: Dobson J

Presented for filing:

Wilson McKay
P O Box 28347, Remuera
Auckland 1541
Telephone: (09) 520-4544
Facsimile (09) 524-0397
Solicitor Acting: **Roger Cann**
RogerCann@wilsonmckay.co.nz

Counsel instructed:

A J Forbes QC office@austinforbesqc.co.nz)
PAB Mills (patricia@saintmarys.co.nz)
AJF Wilding (ajfwilding@xtra.co.nz)
TJP Gavigan (tim@saintmarys.co.nz)
PO Box 2929, Christchurch 8140
Telephone (03) 351-0722
PO Box 47964, Auckland 1144
Telephone (09) 3769297

Table of contents		Page
A.	INTRODUCTION	
1.	Overview	1
2.	Further initial points	5
B.	THE LAW	
3.	The Context	10
4.	Fair Trading Act 1986	11
5.	Securities Act 1978	24
6.	Negligence	46
C.	THE EVIDENCE	
7.	Witnesses	51
8.	Evidence	52
D.	FELTEX	
9.	The company	54
10.	The initial public offer	60
11.	The drafting of the prospectus	62
12.	The prospectus	63
13.	Financial performance post the initial public offer	65
14.	The reasons given by the directors	67
E.	THE CLAIMS	
15.	The statement of claim	71
16.	The parties	72
(i)	<i>Issues with Feltex</i>	
17.	Sales revenue	74
18.	Sales volume	89
19.	Forecast FY2004	100
20.	Projection FY2005	116
21.	Foreign exchange risks	127

22.	Tariffs and imports	131
23.	Extended Credit / Forward dating of invoices	141
24.	Lean manufacturing	157
25.	Feltex was not a good investment	160
(ii)	<i>Treatment and presentation of financial information</i>	
26.	Second bottom line	170
27.	EBITDA	185
28.	SIP Grant and Page 85 of the prospectus	190
(iii)	<i>IPO and sales process</i>	
29.	JLM's proposals to pay \$9 million dividend for FY2004	194
30.	Equity incentive plan	196
31.	May 2004 NZX announcement	204
F.	Promoters	
32.	Credit Suisse MP was a promoter	209
33.	First NZ Capital and Forsyth Barr were promoters	212
G.	RELIANCE	
34.	Reliance by Mr Houghton	216
G.	LOSS	
35.	Loss	219
H.	AFFIRMATIVE DEFENCES	
36.	The defences	220
I.	Schedule A	
37.	Matters admitted or acknowledged by Mr Saunders	228
J.	Schedule B	
38.	Evidence of Mr Thomas in his Securities Commission interview	232

Abbreviations

ARMC	Audit Risk & Management Committee
4ASOC	Further amended statement of claim dated 12 March 2014
Farrar & Watson	J Farrar & S Watson <i>Company and Securities Law in New Zealand (2nd edition)</i> (Thomson Reuters, 2 nd Edition, 2013)
FTA	Fair Trading Act 1986
JLMs	Joint Lead Managers (First NZ Capital and Forsyth Barr)
Morison	<i>Morison's Company & Securities Law</i> (Lexis Nexis NZ Ltd) (looseleaf)
SA	Securities Act 1978
Shaw	Shaw Industries Australia
Todd	S Todd (Gen Ed) <i>The Law of Torts in New Zealand</i> (6 th edn/2013)
Trotman & Wilson	L Trotman & D Wilson <i>Fair Trading Act: Misleading or Deceptive Conduct</i> (2 nd edition, Lexis Nexis, 2013)

A. INTRODUCTION

1.0 Overview

1.1 In June 2004 Feltex Carpets Limited (Feltex) listed on the New Zealand stock exchange. Within 10 months of listing it announced a substantial profit downgrade. Within 27 months it collapsed.

1.2 The downgrade and collapse contrast starkly with the picture painted in the combined prospectus and investment statement of 5 May 2004 (prospectus). That picture was affirmed by the prospectus remaining unaltered in the market until the shares were allotted on 2 June 2004. The plaintiff claims that the prospectus was misleading and deceptive, or likely to mislead or deceive, and that it contained untrue statements and material omissions.

1.3 There were three main categories of problems:

(i) Issues with Feltex

1.4 First, Feltex's decline is consistent with the adverse material circumstances, behaviours of and risks facing Feltex. They were known, or ought to have been known, prior to listing. The main problems are summarised in *Table 1*.

Table 1: Issues with Feltex

Circumstances or risk	Known or ought to have been known pre-IPO	Present post-IPO	Disclosed in prospectus or prior to allotment (including by NZX announcement)
Declining sales volume	Yes	Yes	No
Declining sales revenue	Yes	Yes	No
Forecast FY04 not achievable	Yes	Yes	No (The sales volume and revenue shortfall were not disclosed)
Projection FY05 not achievable	Yes	Yes	No
Use of forward dating to meet revenue targets	Yes	Yes	No
Not all significant customer relations were good	Yes	Yes	No (Customer relations were represented as good)
Increasing domestic	Yes	Yes	No (An assumption of

competition from Godfrey Hirst			static competition was stated)
Likelihood of increased competition from tariff reductions	Yes	Yes	Not adequately. (Increased competition was presented as a risk, not likelihood, and as being mitigated)
Exchange rate risks	Yes	Yes	Not adequately. (Quantification or estimation of the risk was absent)

1.5 The implications of these (and other factors) included that Feltex:

- (a) was not reasonably able to make the assumptions upon which its prospective financial performance stated in the prospectus was based;
- (b) was not likely to meet its FY04 forecast (in terms of sales volume and revenue) nor its FY05 projections (which were not met in any respect);
- (c) was not likely able to meet its forecast and projected dividend payments;
- (d) represented a substantially higher risk as an investment than portrayed in the prospectus. It could not truly be represented as an “excellent investment”.

(ii) Presentation and treatment of financial information

1.6 Secondly, a number of devices were used in the presentation and treatment of financial information in the prospectus, the effect of which was to make less easily understandable or ascertainable the true financial position of Feltex. The main devices are set out in *Table 2*.

Table 2: Presentation and treatment of financial information

Factor	Problem
Use of a second bottom line	Diverted attention from the less favourable bottom line
EBITDA	Non standard term, unduly emphasised, creating a more favourable impression of financial performance
Non-disclosure of the effect of SIP grants on prospective financial information	Created a more favourable impression of financial performance, especially of sales revenue

1.7 These were used despite the knowledge of all defendants that the majority of potential subscribers would be retail investors who were likely to have limited industry, company specific and fiscal knowledge. They would also be likely to rely more on the narrative parts of the prospectus than the financial information.

(iii) IPO and sales process

1.8 Thirdly, the IPO and sales process was misleading and deceptive. The problems are set out below in *Table 3*.

Table 3: IPO and sales process

Circumstance	Known or present pre- registration of prospectus	Known or present pre- allotment	Disclosed
Funding dividend from the public offering	Yes	Yes	No
Poor institutional support for the IPO	Yes	Yes	No
Bookbuild process did not properly follow that represented in prospectus	Yes (in relation to the dividend and institutional support)	Yes (in relation to the dividend and institutional support)	No
24 May 2004	No	Yes	No (Extent of support

announcement over-stated support			was overstated)
Equity incentive plan	Yes	Yes	Extent and nature of benefits not disclosed

Inducement and reliance

- 1.9 The effect of those problems, both individually and cumulatively, was a prospectus and sales process that was likely to mislead or deceive potential investors into believing that Feltex was a better investment than it was. The result was the purchase and continued holding of shares, mainly by retail investors such as the plaintiff.
- 1.10 Any contention of inadequate reliance by Mr Houghton on the prospectus is divorced from the purpose and tenor of the prospectus. Its very purpose was to induce potential investors to subscribe so as to ensure the successful closing of the IPO. A prospectus is a disclosure document, but particularly in this case it was also a carefully drawn marketing document, supported by a sales process headed by the JLMs. Reliance, directly or indirectly, was intended and was known to be very likely to result.

Liability

- 1.11 All defendants were involved in the formulation of the plan and programme pursuant to which shares were offered.
- 1.12 They knew, or ought to have known, of the problems. Many were of a long term nature. They were very unlikely to have only developed in a short time post-IPO. They were reflected in Feltex documents, for example the Group Operating Reports which formed part of the monthly Board papers, internal presentations and the submissions to the Productivity Commission made by Feltex in 2003.
- 1.13 The reality is that Feltex had had only a short period of positive performance, in 2003 and the first half of 2004 (it made losses of \$13,181,000 and \$18,273,000 in FY01 and FY02 respectively, and a loss was to occur in 2H FY04), ¹ which was insufficient to rely on in making the representations

¹ Strangely, the losses in FY01 and FY02 do not feature in the Management Discussion and Analysis on pp81-83 of the prospectus, despite that part referring to financial performance from FY01 forward.

made in the prospectus. Importantly, that brief period of positive performance did not mean there were no problems. There were, both actual and on the foreseeable horizon.

- 1.14 Most of the defendants were involved, to varying degrees, in the drafting of the prospectus and IPO and sales process. They were all required to ascertain or inquire into the appropriateness of its content. However, such inquiry as there was inadequate.
- 1.15 None of the defendants should be relieved of liability. To hold otherwise would be to allow them to reap the rewards of the misleading prospectus and unsatisfactory IPO and sales process, whilst distancing them from the intended effect, being to cause investors to invest, and from their subsequent loss.

2.0 Further initial points

Relevant dates

- 2.1 At the heart of this proceeding is the issue of whether the prospectus contained statements or material omissions which rendered the prospectus misleading or deceptive, or likely to mislead or deceive, (under the FTA) or which were untrue,² (under the SA) in the ways pleaded.
- 2.2 This falls to be evaluated at the time of the conduct, which commenced from 5 May 2004 when the prospectus was issued and continued until 2 June 2004 when the shares were allotted. When assessing the information available to the defendants, the focus is required to be on all material information available to them up to and including that period. That reflects both their knowledge and the prohibition contained in the SA s34 on distributing a prospectus that is or becomes false or misleading in a material particular.

² Under the FTA s9 the issue is whether conduct was misleading or deceptive or likely to mislead or deceive. Under SA s56, it is whether a statement in an advertisement or registered prospectus was untrue. "Untrue" is not defined exhaustively but by s55 a statement is deemed to be untrue if it is misleading in the form and context in which it is included or by reason of the omission of a particular which is material to the statement in the form and context in which it is included. The negligence pleading also claims that the prospectus was misleading or omitted material information.

- 2.3 It follows that information that became available to the defendants only after allotment on 2 June, for example June 2004 sales, cannot be used to justify a representation or statement in the prospectus.

Opinions

- 2.4 It has been contended that certain representations in the prospectus are opinion, and that others were forward looking statements. In some cases, for example the FY04 forecast and FY05 projections, that is correct. However, sharp distinctions between opinion and fact may not have been made by potential investors, the effect upon whom is important.
- 2.5 As importantly, that contention misses the point: the prospectus was designed to sell Feltex, as was the language within it. The impression given was that the positive representations were true and, to the extent they were opinions, that they were justified.
- 2.6 When a board and senior management represent themselves as very experienced and competent, this inevitably will have the effect of lending credibility and thus weight to their opinions. The same applies to endorsement expressly or by association of sophisticated investors (eg Credit Suisse) and professional investment bankers and brokers (the JLMs). That effect cannot be shed now.

Adequacy of disclosure

- 2.7 The adequacy of the disclosure in the prospectus is challenged by the plaintiff. Sufficient disclosure means disclosure in a way that meaningfully and effectively communicates material matters to potential investors. It is not sufficient to merely list risks and identify that if they are realised their impact may be adverse. This concept was recognised in *R v Graham*,³ and sustained on appeal in *Jeffries v R* where the Court of Appeal stated:⁴

...although the amended prospectus referred to the risk of delayed loan repayments, it did not refer to the pattern of marked discrepancies between the company's projections and the actual receipt of funds. And, in conveying an impression of the directors' confidence about the ability of the company to repay investments when due, the amended prospectus omitted to mention the serious

3 [2012] NZCCLR 6 Dobson J

4 [2013] NZCA 188 at [89]

reduction in cash on hand and the directors' concerns about that. While identifying potential risks, the prospectus did not bring home the imminence of them.

- 2.8 A prospectus should give proper guidance as to the nature, significance and consequences of material matters, such as risks, in terms that the prospective reader ought to understand.

First impressions

- 2.9 The prospectus places far more emphasis on the claimed positive attributes of Feltex than the risks of investment. Positive representations are placed earlier, have colourful and (comparatively) more large headings, use active language and create an impression that is unlikely to be dispelled easily. The risks section, which is placed much later at p125, has lower impact headings, uses passive language and describes several relevant risks in a way that suggests they are more apparent than real. The placement and language in the risks section is not sufficiently strong to weigh against the positive impressions earlier created.

The Securities Commission report on Vertex⁵ made the following finding:

The offer document emphasized certain business units of Vertex as being the most significant source of potential growth, but did not give sufficient information about risks associated with those business units. When particular emphasis is given to part of a business as a selling point for the investment, equal emphasis should be placed on material risks associated with that part of the business.

Linking between positive and negative aspects

- 2.10 It is an inadequate answer to a seemingly positive misrepresentation in one part of the prospectus to say that it can be negated by reading another part, unless the two are clearly linked in the prospectus or the negative part is clearly highlighted and sufficiently worded. Allowing proper disclosure within a prospectus to rest upon the ability of a reader to piece the bits together would be to allow an unsatisfactory standard. That is especially so for retail readers with, common sense would suggest, limited analytical ability and a

⁵ Securities Commission 14 March 2003 "A report on aspects of the Initial Public Offering of Vertex Group Holdings Limited in 2002"

tendency to focus on the glossy bits. This tendency was recognised by senior counsel for the first defendants in his cross-examination of Mr Houghton. ⁶ There is no reason why a prospectus cannot be laid out in a way that presents positive representations and risks together and with equal emphasis.

Post-IPO announcements and statements

- 2.11 A word is also appropriate about the significance of Feltex’s NZX revenue shortfall and profit downgrade announcements made from April 2005, the 2005 AGM addresses by Mr Saunders and Mr Thomas and statements made by them to the Securities Commission when interviewed. They recognised major problems within Feltex from only 10 months and onwards after the IPO, from which they now seek to shield under the guise of “hindsight”. While a “hindsight” analysis is inappropriate,⁷ that does not water down the significance of the matters recognised by them.
- 2.12 First, they are factual acknowledgements that the problems referred to actually existed. Many were clearly structural. The Court can apply common sense and look to other evidence, for example falling sales volume and sales revenue, which were manifest in the second half of FY04, to assist in determining when the problems acknowledged likely arose, and when they, or a significant risk of them occurring, could and should have been apprehended by the defendants.
- 2.13 Secondly, their nature and scale can assist in evaluating the reasonableness of the defendants’ behaviour. Can defendants with the competence, experience and professionalism represented by them, both expressly and implicitly, reasonably not have been aware of such problems at the time of the IPO, or that there were then significant risks they would develop?
- 2.14 It is apparent that defendants place weight on the decision of the Securities Commission dated October 2007. It neither binds nor bears on the present case and should be disregarded. There is no evidence as to the extent to which the evidence before the Commission equated with that before the Court. Almost certainly it was substantially less. Likewise the nature and extent of the claims made by the plaintiff.

⁶ Houghton NOE page 72 line 24 to page 78 line 11

⁷ *R v Moses* HC Auckland, CRI 2009-004-1388, 8 July 2011, per Heath J at [29]

Affirmative defences

- 2.15 The defendants claim that the due diligence process was thorough and as such they should be relieved from liability suggests far too narrow an inquiry. A defence should rest on substance, not just process. Diligence in ignorance is not due diligence. Relevant to any honest and reasonable defence are issues such as:
- (a) what information the defendants had or had available to them upon proper inquiry prior to registration and allotment and whether and how they brought that to bear in the due diligence process and prospectus?
 - (b) what information they provided to the professional advisers upon whom they relied, whose opinions were in any event substantially qualified as to the limits of the advice they respectively gave?
 - (c) whether the layout, presentation and language in the prospectus show all reasonable efforts were made to ensure that an accurate and balanced picture of Feltex was conveyed?

First stage trial

- 2.16 This is the first stage of a potential two stage trial. The quantum of loss for other qualifying shareholders represented by the plaintiff does not presently arise. However, if common issues are determined in favour of the plaintiff and those he represents then the issue of loss for those represented should be able to be resolved on an accounting basis from an independent expert or on inquiry.

B. THE LAW

3. The context

- 3.1 The issuing of securities is highly regulated. Prospectus' and investment statements must contain sufficient information for a potential investor to make an informed decision about whether to invest. Candour and care are required with such disclosure.

- 3.2 The reason for that is commonsense: the public does not know the workings of the company the subject of the prospectus and investment statement, nor often much if anything about the relevant industry and conditions. They are thus highly reliant on the company and industry information provided in a prospectus and investment statement in deciding whether to invest.
- 3.3 At the relevant time the main statutory mechanisms for regulation were the FTA and the SA. Tortious negligence provides a common law mechanism. They are turned to below.

4. The Fair Trading Act 1986

Misleading or deceptive

- 4.1 The FTA s9 prohibits misleading and deceptive conduct. It provides:

No person shall, in trade, engage in conduct that is misleading or deceptive or is likely to mislead or deceive.

- 4.2 Upon a breach various statutory remedies are available pursuant to s43 for those who have suffered or are likely to suffer loss or damage as a result of the contravention of s9.

- 4.3 Pursuant to s2(1)

“trade” means any trade, business, industry, profession, occupation, activity of commerce, or undertaking relating to the supply or acquisition of goods or services...”.

“Business” means any undertaking –

- a. that is carried on whether for gain or reward or not; or*
- b. in the course of which –*
 - (i) goods or services are acquired or supplied;...*
 - (ii) whether free of charge or not.”⁸*

- 4.4 The definitions have been drawn broadly⁹ and it is submitted apply to each of the defendants.
- 4.5 Whether an act or statement is misleading or deceptive is a question of fact, determined objectively in all the circumstances.

⁸ *Concrete Constructions (NSW) Pty Ltd v Nelson* (1990) 169 CLR 594, 603 and *Pharmaceutical Management Agency Ltd v Researched Medicines Industry Association New Zealand Inc* [1996] 1 NZLR 472, 475

⁹ Trotman & Wilson at [2.3]

- 4.6 In assessing whether conduct is misleading or deceptive or likely to mislead or deceive the conduct must be considered as a whole: see the leading Australian case *Parkdale Custom Built Furniture Pty Ltd v Puxu Pty Ltd*:¹⁰

*The conduct of a defendant must be viewed as a whole. It would be wrong to select some words or acts which, alone, would be likely to be misled if those words or acts, when viewed in their context, were not capable of misleading. It is obvious that where the conduct complained of consists of words it would not be right to select some words only and then ignore others which provided the context which gave meaning to the particular words. The same is true of acts. The words "mislead" and "deceive" do not require judicial exegesis.*¹¹

- 4.7 In *Henjo Investments Pty (No 1) Ltd v Collins Marrickville Pty Ltd*¹² the definitions in the compact edition of the Oxford English Dictionary 1987 were adopted. "Mislead" meant "to lead astray in action or conduct; to lead into error; to cause to err;" and "deceive" meant "to ensnare; to take unawares by craft or guile; to overcome, overreach, get the better of by trickery; to beguile or betray into mischief or sin; to mislead". The court noted that mislead does not necessarily involve an element of intent, and is of wider reach than deceive.

- 4.8 "Likely to" imports a lesser degree of likelihood than more probable or not.¹³ In *Gregory v Rangitikei District Council*¹⁴ McGechan J stated:

A tendency in the action concerned will suffice. There must be, however, a misleading or deception (or a likelihood in the sense of real possibility). Mere confusion, or wonderment, at a lower level will not suffice.

- 4.9 However, it appears there may be a small step between confusion and being misled or deceived: see *Taylor Bros Ltd v Taylor Group Ltd*¹⁵ per Cooke P:

It is not enough that the conduct causes a state of wonder or doubt in the minds of people about, for example, the identity or otherwise of two businesses. The line in the latter respect can be a fine one, we think, for if the Court is satisfied (on the balance of probabilities) that some consumers will wonder, it may at times not be difficult to take the further step of concluding that some are likely to be misled; but of course this is not necessarily so.

¹⁰ (1982) 149 CLR 191, 196 (HCA)

¹¹ *Taylor Bros Ltd v Taylor Group Ltd* [1988] 2 NZLR (CA) at [39]

¹² (1982) 149 CLR 191, 195

¹³ *Bonz Group Pty Ltd v Cooke* [1994] 3 NZLR 216 (HC); (1996) 7 TCLR 206 (CA)

¹⁴ [1995] 2 NZLR 208, 233

¹⁵ [1988] 2 NZLR 1, 39

- 4.10 Trotman & Wilson¹⁶ suggest that, based on *Healthy Food Media v Healthy Options Ltd*,¹⁷ there may not be a difference between a finding of confusion or of misleading or deceptive conduct. And the text adds that the attempt to articulate a difference between the terms “confusing” and “misleading or deceptive” has been unhelpful and suggest that whether the conduct is to be considered as misleading or deceptive is a question of fact to be determined by considering the effect of the conduct on the party complaining. Thus in *Quinn Group v Quin Work Force*¹⁸ Venning J commented that “*misleading or deceptive conduct is required. That will be shown by confusion on the part of consumers*”. That decision then went on to consider whether the confusion was reasonable.
- 4.11 Technical accuracy does not shield deceptive and misleading conduct. Trotman & Wilson states:¹⁹
- 3.32 *The fact that the information was technically correct, as in Geddes, does not prevent it from creating a misleading impression on a person, and provided this impression was reasonable, it should correctly be categorised as misleading or deceptive conduct.*
- 3.33 *This was recognised in a High Court judgment decided just prior to Geddes. In Body Corporate No 202254 v Approved Building Certifiers Ltd* ²⁰ *it was argued that a description of the exterior of a unit in a housing development as a “plaster system on breathable membrane and substrate” as a single “thing” could not be misleading as it was a literal description of the system, and that this was supported by the trade literature. The argument was therefore that the plaintiffs were confused by specialised terms similar to the situation in Geddes. Kean J approved the approach of the Associate Judge in a previous striking out application that the trade literature was not definitive, and concluded that it was only part of the evidence to be considered in deciding whether the statement was misleading or deceptive.*
- 4.12 Intention, while not necessary, ²¹ may be taken into account in determining whether conduct is misleading or deceptive. ²² However, the evidence that a person acted honestly and reasonably will not affect a finding that conduct

16 At [3.34]

17 HC Auckland, CIV2005-404-6486, 16 November 2005, Asher J at [23]

18 HC Auckland, CIV2007-404-3469, 26 October 2007, Venning J at [49]

19 At [3.32]

20 HC Auckland CIV2003-404-3116, 13 April 2005, Kean J

21 *Goldsbro v Walker* [1993] 1 NZLR 394 (CA); Trotman & Wilson at [3.37]

22 Trotman & Wilson at [3.39]

is misleading and deceptive. **23** Absence of knowledge is also not relevant, the focus being on the impression given to the other party. **24**

- 4.13 The test for misleading or deceptive conduct was stated by the Court of Appeal in *AMP Finance NZ Ltd v Heaven*. **25** That required three steps, first asking whether the conduct in question was capable of being misleading; then secondly considering whether the plaintiffs were in fact misled by the relevant conduct. That focused on the effect of the relevant conduct on the plaintiffs' mind. The third step was considering whether in all the circumstances it was reasonable for the plaintiffs to be misled. That involved an objective element. It was not sufficient for the plaintiffs to show they were misled if reasonable people in their shoes would not have been misled.
- 4.14 *Heaven* was re-examined by the Supreme Court in *Red Eagle Corp Ltd v Ellis*, **26** which expressed the view that the formulation in *Heaven* was not intended to apply to all situations. *"It is not desirable to attempt to formulate a methodology to be applied prescriptively by a court whenever the application of these provisions is in issue, for the circumstances are too variable."* **27**
- 4.15 The Supreme Court adopted a one-step test to determine whether the conduct was misleading or deceptive and thus breached s9, this being to ask whether a reasonable person in the claimant's situation would have been misled or deceived.
- 4.16 Blanchard J (for the Court) further stated that whether the person was actually misled or deceived was determined at the loss stage.

Then, with breach proved and moving to s43, the court must look to see whether it is proved that the claimant has suffered loss or damage 'by' the conduct of the defendant. The language of s43 has been said to require a 'common law practical or common-sense concept of causation'. The court must first ask itself whether the particular claimant was actually misled or deceived by the defendant's conduct. It does not follow from the fact that a reasonable person would have been misled or deceived (the capacity of the conduct) that the particular claimant was actually misled or deceived. If the

23 Trotman & Wilson at [3.44]

24 Trotman & Wilson at [3.49]; *Hutchinson v Solomon Weather Tight Homes Resolution Service*, (No 01993, 20 June 2006, Adjudicator D M Carden)

25 (1997) 8 TCLR 144 (CA)

26 [2010] 2 NZLR 492 (SC)

27 At [26], per Blanchard J (for the Court)

court takes the view, usually by drawing an inference from the evidence as a whole, that the claimant was indeed misled or deceived, it then needs to ask whether the defendant's conduct in breach of s9 was an operating cause of the claimant's loss or damage. Put another way, was the defendant's breach the effective cause or an effective cause?

...the impugned conduct, in breach of s9, does not have to be the sole cause, but it must be an effective cause, not really something which was in the end, immaterial to the suffering of the loss or damage. The claimant may, for instance, have been materially influenced exclusively by some other matter, such as advice from a third party. 28 [Original emphasis]

- 4.17 Another operating cause of loss or damage may be a failure by a claimant to take reasonable care. The fact that a claimant has contributed by carelessness to his or her own downfall does not disqualify the claim. 29 That is a factor which may be taken into account in assessing relief. The exercise of the power to make an order for payment under s43 is "...a matter of doing justice to the parties in the circumstances of the particular case and in terms of the policy of the Act." 30

Relevant section of the public

- 4.18 The third step in *Heaven* 31 requires consideration of whether in all the circumstances it was reasonable for the plaintiff to be misled, and as such imports an objective element. Relevant to that is assessment of the audience, known as the relevant section of the public. That is interpreted broadly. Thus in the context of an auction of a house the Court of Appeal considered the relevant section of the public would consist of all of those with an actual or potential interest in purchasing the property, whether at the auction or subsequently. 32
- 4.19 A similar concept appears the Supreme Court's judgment in *Red Eagle Corp Ltd v Ellis*, 33 where it was stated:

That section is directed to promoting fair dealing in trade by proscribing conduct which, examined objectively, is deceptive or misleading in the particular circumstances. Naturally, that will depend upon the context, including the characteristics of the person

28 At [29]

29 At [30]

30 At [31]

31 (1997) 8 TCLR 144

32 *Commerce Commission v Grenadier Real Estate* [2004] 2 NZLR 186 (CA)

33 At [28]

or persons said to be affected. Conduct toward a sophisticated businessman may, for instance, be less likely to be objectively regarded as capable of misleading or deceiving such a person than similar conduct directed towards a consumer or, to take an extreme case, towards an individual known by the defendant to have intellectual difficulties. Richardson J in Goldsbro v Walker said there must be an assessment of the circumstances in which the conduct occurred and the person or persons likely to be affected by it. The question to be answered in relation to s9 in a case of this kind is accordingly whether a reasonable person in the claimant's situation – that is, with the characteristics known to the defendant or of which the defendants ought to have been aware, would likely have been misled or deceived...

- 4.20 It is anticipated that in this case the relevant section of the public may be that used for the purpose of the SA. However, caution needs to be expressed about the capacity of such a cross-section. **34**

Time at which conduct is to be assessed

- 4.21 The conduct and consequences are to be assessed at the time the conduct occurred. Thus in *Taco Company of Australia Inc v Taco Bell Pty Ltd*,**35** an attempt to argue that a contravention must be proved to occur at the point of sale was not accepted. Trotman & Wilson **36** notes:

*The reason for this is seen in St Lukes Health Insurance v MBF³⁷, where it was held that a correction at point of sale did not alter the fact that misleading or deceptive conduct occurred in the first place.³⁸ In Luxottica Retail New Zealand Ltd v Specsavers New Zealand Ltd, ³⁹ the Judge said simply that “**First impressions are what count in this kind of advertising**”. In *Quinn Group v Quin Work Force*, on the other hand, the fact that ‘inquiries or other available sources of information would be likely to reveal the true position before any step was taken in reliance upon the representation’ ⁴⁰ was relevant. [Emphasis added]*

- 4.22 The emphasised part conveys a concept of especial relevance here. The early stages of the prospectus convey an impression that is overwhelmingly positive. The later parts would need to be couched in very strong terms to

34 See, for example, Professor Barbara Black *Behavioural Economics and Investor Protection : Reasonable Investors, Efficient Markets* (Loyola University Chicago Law Journal vol 44, p1493). Prof Black discusses behaviour economics, the efficient market hypothesis, the fallibilities of investors and investor protection.

35 (1982) 42 ALR 177, 199

36 At [3.92]

37 (1995) ATPR 40,820

38 See also *SAP Australia Pty Ltd v Sapient Pty Ltd* (1999) 169 ALR 1, [51]; *Peter Bodum v DKSH Australia Pty Ltd* (2011) 280 ALR 639

39 (2001) TCLR 449, [26]-[27]

40 *Quinn Group v Quin Work Force*, HC Auckland, CIV2007-404-3469, 26 October 2007, Venning J, [50]

weigh against it. This is turned to later. The impression gained in the first part of a prospectus will condition the way the second part of the prospectus is read.

- 4.23 The whole of the context must be considered, and as such words or conduct should not be taken in isolation. If an advertisement is part of a larger campaign then the impression obtained from an earlier related advertisement may be taken into account.⁴¹
- 4.24 “*The mediums and the settings*”⁴² must not be lost sight of. Thus in the case of a television commercial it is important to understand the circumstances in which it was viewed. Submitted that the circumstances of a prospectus are such that the statements and representations in it will be taken seriously. Mere “puffery” would be more expected in media advertising such as a television or radio advertisement, than a formal document regulated by and required to be registered by statute and constituting an offer open for acceptance.

Non-disclosure or silence

- 4.25 An omission to provide information may be misleading even if no obligation to provide such information exists under the general law.⁴³ In *Hieber v Barfoot & Thompson Ltd*⁴⁴ the Australian test of whether there is a reasonable expectation of disclosure was applied. In *Demagogue Pty Ltd v Ramensky*⁴⁵, on appeal to the full Federal Court of Australia, Black CJ said:

Silence is to be assessed as a circumstance like any other. To say this is certainly not to impose any duty of disclosure; the question is simply whether, having regard to all the relevant circumstances, there has been conduct that is misleading or deceptive or that is likely to mislead or deceive. To speak of ‘mere silence’ or of a duty of disclosure can divert attention away from that primary question. Although ‘mere silence’ is a convenient way of describing some fact situations, there is in truth no such thing as ‘mere silence’ because the significance of silence always falls to be considered in the context in which it occurs. That context may or may not include facts giving rise to a reasonable expectation, in the circumstances of the case, that if particular matters exist they will be disclosed.

41 *ACC v Telstra Corporation Ltd* (2007) 244 ALR 470, [20]; *Singtel Optus Pty Ltd v Telstra Corporation Ltd* [2004] SCA 859

42 *Nick Scali v Super A Mart* [2011] FCA 751, [91]

43 *Des Forges v Wright* [1996] 2 NZLR 758, 764 per Elias J

44 (1996) 5 NZBLC 99, 384

45 (1992) 39 FCR 31, 32

- 4.26 This has developed into a test of reasonable expectation of disclosure. In *Guthrie v Taylor Parris Group Cossey Ltd* **46** Priestly J stated:

The real issue to be determined is whether there is something about the circumstances of the transaction which gives rise to a reasonable expectation that one party would volunteer information as to matters of importance to the other.

- 4.27 Submitted that the requirement for disclosure in the context of an offer for securities clearly imports the reasonable expectation of sufficient disclosure. Additionally there is a reasonable expectation that where information is provided it is accurate and complete.**47**
- 4.28 An expectation can extend to include the requirement to provide information even not asked about. As stated in the Australian case of *Fleetman Pty Ltd v Cairns Pty Ltd*:**48**

The failure to ask the question ... was because the conduct of the appellant was misleading or deceptive. In such circumstances, conduct is no less misleading or deceptive because the consumer might have asked more questions which might have exposed the real facts. Often the absence of probing questions will be precisely because conduct has been engaged in which as a fact is found to have been misleading or deceptive.

- 4.29 Trotman & Wilson**49** describe six circumstances in which saying nothing can create a false impression, being:

1. *where what is said amounts to a half-truth;*
2. *where what is said is literally true, but conveys a false impression;*
3. *where what is said is true at the time, but the maker of the statement then becomes aware of different circumstances and does not pass this information on;*
4. *where there is a particular relationship requiring utmost good faith;*
5. *where the silence can be seen as confirming a wrong belief of one party that is known to the silent party; and*
6. *where there is a failure to reveal information the other party feels should be revealed.*

46 (2002) 10 TCLR 367, [21]; Trotman & Wilson at [4.24]

47 Trotman & Wilson at [4.36]

48 [2005] FCAFC 80, [70]; See also *Hinton v Commissioner for Fair Trading* [2006] NSW ADT 257

49 At [4.51]

4.30 There have been diverging views regarding whether s9 requires there to be a misrepresentation. The authors of Trotman & Wilson note that if there is a misrepresentation requirement under s9 then only the first four listed above will amount to a misrepresentation,⁵⁰ but on the other hand there are situations where mere silence might lead to a reasonable expectation of disclosure.⁵¹ The text says that this may be an exception where a misrepresentation is not required. It suggests that both tests can be reconciled by circumstances that are potentially covered by a reasonable expectation test forming an exception to any misrepresentation requirement.⁵²

Statements of fact and statements of opinion

4.31 The line between opinion and fact is inherently difficult to define.⁵³ At common law where facts are not equally known to both sides

“...a statement of opinion by one who knows the facts best involves very often the statement of material fact, for he impliedly states that he knows facts which justify his opinion.”⁵⁴

4.32 In *McAlpine Snowline Ltd v Wethey*⁵⁵ a statement of opinion was considered to contain a representation that the opinion was genuinely held. In the Australian case *SWF Hoists & Industrial Equipment Pty Ltd v State Government Insurance Commission*⁵⁶ Von Doussa J stated:

The distinction between fact and law is often very difficult to draw, and a distinction in any event becomes one of academic interest only if the representation involves mixed questions of law and fact. ... in my opinion these representations constitute representations of fact. In effect, the respondent said to the applicant ‘in this package there is a policy which will cover you....

4.33 In Australia the common law categorisation of whether the conduct is opinion or law is not determinative. The issue is whether the conduct contravenes the relevant statutory provisions.⁵⁷

4.34 The effect of the statement on the person hearing it can also be relevant.⁵⁸

50 At [4.53]

51 At [4.54]

52 At [4.56]; See also *Bonz Group Pty Ltd v Cooke* (1996) 7 TCLR 206, 210

53 At [5.8]

54 *Smith v Land and House Property Corporation* (1884) 78 ChD 7, 15; Trotman & Wilson at [5.9]

55 (1986) 2 NZCPR 388, 396

56 (1990) ATPR 41-045

57 Trotman & Wilson at [5.11]

- 4.35 An opinion may involve two representations of fact, one being that the opinion is honestly held and the other that there is a reasonable basis for it.⁵⁹
- 4.36 In *Looker v Till* ⁶⁰ a requirement of reasonable reliance on opinion was applied. A real estate agent (Mr McAllum) had expressed a view as to there being “in my professional opinion as a real estate agent and as a former farmer there is more than 200 acres of grass”. It was held that “*Though honestly given the answer was inaccurate and, as the only third party to that conversation who knew the facts, the answer impliedly suggested that Mr McAllum knew that the factual position supported his answer...*”. It was held there was no reason why the plaintiffs should not have relied on what was said.⁶¹
- 4.37 Providing an opinion in the form of information can be misleading if there is a suggestion that the information is unbiased or complete, and that is not the case. In *Mackman v Stengold Pty Ltd* ⁶² an advertisement referred to income that would be generated from a business that was offered for sale. A number of documents were made available to applicants by the vendor including a profit and loss statement in the name of a firm of accountants, which was false, but was based on information provided by the vendor. It also included a disclaimer as to liability. The claim succeeded against the accountants. Spender J held that:

*... the only use of the preparation of those documents was to persuade persons to purchase franchises for the supply of the motor vehicle protection system.*⁶³

Negligent professional advice

- 4.38 Liability can co-exist under the Act and in negligence. ⁶⁴ In *Gilrose Finance Ltd v Ellis Gould* ⁶⁵ the plaintiffs asked the defendant solicitor about the

58 See *Australia SWF Hoists & Industrial Equipment Pty Ltd v State Government Insurance Commission* (1990) ATPR 41-045 [42]; *Tobacco Institute of Australia Ltd v Australian Federation of Consumer Organisations* (1992) 38 FCR 1; Trotman & Wilson at [5.16]-[5.19]

59 *Premium Real Estate Ltd v Stevens* [2009] 1 NZLR 148, [51]-[54]; Trotman & Wilson at [5.25]

60 HC New Plymouth, CP17/95, 6 December 1999, Hugh Williams J

61 *Looker v Tool*, HC New Plymouth, CP17/95, 6 December 1999, Hugh Williams J [79]; cf *Robinson v Hemachandra Holdings (NZ) Ltd*, HC Dunedin, CIV2004-412-307, 17 June 2005, Fogarty J; see also *AMP Finance NZ Ltd v Heaven* (1997) 8 TCLR 144

62 (1991) ATPR 41-105

63 At 41-105, 52, 632

64 See *Gilrose Finance Ltd v Ellis Gould*, HC Auckland, CP 498/96, 16 October 1997, Paterson J; *Harris v Simonetta* (1998) 8 TCLR 472; Trotman & Wilson at [5.41]

trustworthiness of a potential business partner and were told that they were trustworthy. The plaintiffs entered into a contract and were defrauded. The Judge did not see any reason why the solicitors could not be liable under the FTA and in negligence.

Unfulfilled promises or predictions

- 4.39 Statements as to the future breach the Act if they are not reasonably based on information available at the time or it was not unreasonable to rely on that information.⁶⁶ However, the mere fact that representations as to future conduct were not correct does not of itself mean they were misleading or deceptive. ⁶⁷ The statements must be assessed at the time that they were made. This parallels the position with opinions. It is to be distinguished from situations where the promisor did not at the time of making the promise have any intention to deliver on it.
- 4.40 There has been conflict as to whether the test is subjective or objective. In *Commerce Commission v Chalmers* ⁶⁸ the representations (considered pursuant to s13 of the FTA) needed to be evaluated in light of all of the circumstances to determine their true content and character. In *Parapine Timber Products Ltd v Redington* ⁶⁹ an objective test was also applied by the Court of Appeal.
- 4.41 However it appears that a subjective test may currently be preferred. In *Dymocks Franchise Systems (NSW) Pty Ltd v Bigola Enterprises* ⁷⁰ Hammond J stated:

In determining whether a statement is misleading or deceptive, again a distinction must be made between statements as to existing facts, and predictions as to the future. Predictions as to the future will only be misleading or deceptive if the person making the prediction knew it to be false or did not have an appropriate basis for making such a statement. As with the common law, a statement relating to the future may contain an implied statement as to present or past facts. That is, the statement may impliedly represent that the promisor has a present intention to make good the promise, and impliedly represent that the person has the means of doing so, in which case the

65 HC Auckland, CP 498/96, 16 October 1997, Paterson J

66 Trotman & Wilson at [6.6]

67 *Muollo v Creative Engineering Design Ltd* (2006) 8 NZBLC 101, 675

68 (1990) 3 TCLR 522

69 CA 266/92, 10 May 1993

70 (1999) 8 TCLR 612 at [302]. Trotman & Wilson at [6.23] refer to other subsequent cases that have followed this approach.

statement may breach s9 or s52, if the implied present or past fact is not true.

- 4.42 The authors of Trotman & Wilson **71** express the view that the current position in New Zealand is uncertain. They suggest, however, that the subjective approach is inconsistent with other FTA cases and the fact that lack of fault or intention to mislead are not relevant in determining liability under s9. They suggest that the courts should follow *Commerce Commission v Chalmers* **72** and *Parapine Timber Products Ltd v Redington*.**73**

Causation

- 4.43 The approach to causation was stated by the Supreme Court in *Red Eagle Corporation Ltd v Ellis***74**: see para 4.16 above.
- 4.44 Whether a person was actually misled or deceived is a subjective question. Trotman & Wilson**75** state that it does not follow from the fact that a reasonable person would not have been misled or deceived that the particular claimant was not misled or deceived. Thus, it is not necessary that it was reasonable for a person to have been misled or deceived. In *Waikatolink Ltd v Comvita New Zealand Limited***76** Rhys Harrison J commented that:

... reasonableness of reliance does not feature in the elements of liability but in fixing compensation.

- 4.45 Reliance will not be generally considered reasonable if a plaintiff was in as good a position as the defendant to know or ascertain facts.**77** But lack of prudence is not determinative: see *Vining Realty Group Ltd v Moorhouse***78**:

*It does not normally sit well in the mouth of someone who has been guilty of misrepresentation to blame the other person for believing the misrepresentation.***79**

71 At [6.24]

72 (1990) 3 TCLR 522

73 CA 266/92, 10 May 1993

74 [2010] 2 NZLR 492, [29]

75 At [12.14]

76 (2010) 12 TCLR 808, [168]; See also *Zang v VP 302 Pty Ltd* (2009) 14 BPR 27, 505 [109] where it was commented that “naïve reliance would suffice”

77 *Lam v Ausintel Investments Australia Pty Ltd* (1989) 97 FLR 458

78 (2010) 11 NZCPR 879 [51]

79 See also Trotman & Wilson at [12.14] – [12.20]

- 4.46 If a person was actually misled or deceived then the issue of causation arises. The conduct does not have to be the sole cause of the loss, but it must be *an effective cause*, rather than immaterial.⁸⁰
- 4.47 It is noted by Trotman & Wilson⁸¹ the court will look at loss in a practical and common-sense way, with fairness and reasonableness. Both are of relevance:

*Once a court has decided that a person was actually misled or deceived by conduct, and the loss flowed from their conduct being misled or deceived, it will often not be difficult for it to infer that the conduct was an effective, if not the effective, cause of the loss.*⁸²

- 4.48 The fact of multiple effective causes of loss can bear on the quantum of relief: see *GPE Holdings Ltd v BASF New Zealand Ltd*:⁸³

Naturally, where there are multiple operative causes, the award of compensation may be reduced to reflect causes for which a defendant is not responsible.

- 4.49 Carelessness by a plaintiff may bear on quantum, and must be proven by the defendants. That may impact on the damages award but does not mean that the claim is not sustainable.⁸⁴

Remedies

- 4.50 Section 43(2) of the Act provides for a range of remedies which may be made individually or in combination if that is necessary to achieve justice.⁸⁵ Its object is to enable justice to be done between the parties.⁸⁶
- 4.51 An important remedy is declaring a contract void (s43(2)(a)). Declaring a contract void reflects the situation where a party would not have entered into the contract in question but for the misleading or deceptive conduct.
- 4.52 That remedy may not be appropriate where a misrepresentation touches only a minor aspect of the agreement.⁸⁷ If avoidance is not appropriate then damages are more likely. Avoidance under s43(2)(a) is effectively the same

⁸⁰ *Red Eagle Corp Ltd v Ellis* [2010] 2 NZLR 492 at [29]

⁸¹ At [12.33]-[12.34]

⁸² At [12.34]

⁸³ HC Wellington, CIV2010-485-183, 12 May 2010, Gendall J

⁸⁴ *McKeown Group Ltd v Russell* (2010) 13 TCLR 1; *Red Eagle Corp Ltd v Ellis* [2010] 2 NZLR 492 (SC)

⁸⁵ Trotman & Wilson at [13.2]-[13.3]

⁸⁶ *Red Eagle Corp Ltd v Ellis* [2010] 2 NZLR 492 at [31], referring to *Goldsbro* per Richardson J at 404

⁸⁷ *Akron Securities Ltd v Iiffe* (1997) 41 NSWLR 353, 368; Trotman & Wilson at [13.19]

as cancellation under the Contractual Remedies Act 1979 (CRA).⁸⁸

Trotman & Wilson express the view, however, that the discretion under s43 should not be fettered by the CRA, contract or tort rules.⁸⁹

4.53 A refund of money or return of property (s43(2)(c)) may be appropriate where money has been paid or property transferred as a consequence of misleading conduct.⁹⁰

4.54 An order for refund of money may involve the setting up of a refund scheme, eg where there is a large class of people entitled to relief. In such cases the court has a responsibility to work out an interpretation that accords with the purpose of the Act. A person ordered to make refunds may have to pay the administrative costs of such a scheme.⁹¹

5. The Securities Act 1978

Purpose

5.1 The SA is intended to regulate the offering of securities to the public.⁹² An “offer of securities to the public” includes the distribution of an advertisement, a prospectus, a registered prospectus or an application form for the subscription of securities.⁹³

5.2 The Act is directed at investor protection. The Act primarily achieves its purpose by placing upon those who know or ought to know the relevant information, those who are instrumental in the preparation and formulation of an offer and those who benefit from an offer of securities, a duty to disclose and not mislead.

5.3 In *Moses Heath* ⁹⁴ referred to *Re AIC Merchant Finance Limited*⁹⁵ that the purpose of the Act is the protection of investors. Heath J stated:

The underlying policy is simple. Full disclosure enables a potential investor to make an informed decision whether to invest. Equally, a

88 Trotman & Wilson at [13.35]

89 At [13.38]

90 At [13.55]

91 *Commerce Commission v O'Neill* (2007) 12 TCLR 1, [13]-[32]

92 SA, Long title

93 SA, s3(4)

94 *R v Moses* HC Auckland CRI-2009-004-1388, 8 July 2011 at [36] At [36]

95 [1990] 2 NZLR 384 (CA) per Richardson J at 391-392

potential investor cannot make an informed choice without all information that is both relevant and material to the decision.

Who the Act protects

- 5.4 The Act contemplates that the audience for a prospectus and investment statement is a “*prudent but non-expert*” person, known as a notional investor. In *R v Moses* Heath J attributed to that person:⁹⁶
- (a) a risk profile falling somewhere between a person who is risk averse and a person who is prepared to take a high level of risk. They know that the higher the interest rate offered the greater the risk of loss;
 - (b) an understanding of the language used in the narrative sections of the investment statement and prospectus, including a general understanding of some technical words and financial jargon. The notional investor would focus more on the narrative parts of offer documents than on financial statements;
 - (c) the seeking and likely ability to comprehend competent investment advice.
- 5.5 In *R v Graham* ⁹⁷ Dobson J expressed reservation about the third attribute. Some notional investors may not seek advice and Parliament must have recognised that they may not do so: “*The notional investor should extend to some who have less than a complete understanding of all content, but do not take advice.*” ⁹⁸
- 5.6 That reflects the scheme of the Act. It regulates the offer and advertising of “...*securities to the public.*”⁹⁹ That purpose is not qualified by reference to intermediary advisors. The misrepresentation provisions and imposition of (essentially) strict liability for criminal offences reflect the need for candour to ensure that the public is not misled.
- 5.7 Submitted the Act is not directed at protection of directors and others for issuing and advertising a prospectus that may mislead the non-expert eye,

⁹⁶ At [64]-[67]

⁹⁷ *R v Graham* [2012] NZHC 265 at [26]

⁹⁸ At [27]

⁹⁹ SA, Long title

but with professional assistance can be analysed so as to give a true picture of the subject company.

Requirement to not mislead and liability

- 5.8 The requirement to not mislead is high. Section 34 prohibits the distribution of misleading prospectus:

34 Restrictions on distribution of prospectuses

(1) *No registered prospectus shall be distributed by or on behalf of an issuer,—*

(a) after it has been amended unless all the amendments have been incorporated in, or attached by way of an instrument to, every copy of the registered prospectus that is so distributed; or

(b) if it is false or misleading in a material particular by reason of failing to refer, or give proper emphasis, to adverse circumstances (whether or not it became so misleading as a result of a change in circumstances occurring after the date of the prospectus)...

- 5.9 Under s56 of the Act civil liability attaches to “*untrue statements*”.

- 5.10 Section s55(a) deems certain statements untrue. It provides:

55 Interpretation of provisions relating to advertisements, prospectuses, and registered prospectuses

For the purposes of this Act,—

1. a statement included in an advertisement or registered prospectus is deemed to be untrue if—

- a. it is misleading in the form and context in which it is included; or*
- b. it is misleading by reason of the omission of a particular which is material to the statement in the form and context in which it is included:*

- 5.11 Section 55(a) is a deeming provision. It does not, on its face, define an untrue statement, or provide an exhaustive definition. Definition sections usually use the word “*means*”.

- 5.12 It deems certain things untrue statements with reference to the concept of “*misleading*”. A statement could be misleading for many reasons other than those stated. A logical example is that in s34(1)(b). It would be very surprising if a prospectus that was considered misleading by reason of

omission under s34 could not be caught by s56 because of the deeming definition in s55.

- 5.13 “*Statement*” is not defined in s55. It is an elastic concept. It may be a sentence, a paragraph, the majority or even the whole of the prospectus. A narrower reading would not advance the object of the act.
- 5.14 Submitted a contention that s55 is an exhaustive definition of an untrue statement for the purpose of liability under s56, and that an omission must be linked to a particular statement (read narrowly), would run counter to the object of the Act.
- 5.15 A particular problem would arise with certain omissions that cannot be logically or easily linked to a particular statement in a prospectus. The result would be:
- (a) an omission could be considered misleading under the FTA regardless of whether it is linked to a particular statement in a prospectus;
 - (b) but there is no liability under the SA, because the omission is not linked to a particular part of a prospectus.
- 5.16 It is unlikely that this was Parliament’s intention. This is not going so far as to say that there must not be a connection between the omission and the prospectus and statements in it. In *Jeffries v R* **100** the Court of Appeal stated, in relation to s58, which imposes criminal liability for untrue statements:

[85] The Act and the Regulations make it abundantly clear that the statutory intention is to prohibit false or misleading material in a prospectus. In this respect we have already mentioned s 34(1)(b) of the Act which prohibits the distribution of a registered prospectus which is false or misleading in any material particular. That may arise from either a failure to refer to adverse circumstances or to give proper emphasis to any such adverse circumstances. The Securities Regulations in force at the time also required additional information to be provided in a prospectus if a statement required in the prospectus would be misleading without that additional information.

[86] Criminal liability under s 58 of the Act is properly viewed as supporting the disclosure regime by the imposition of criminal sanctions. The obligation not to include false or misleading

statements in a prospectus or other offer document extends by s 55 to the omission of material information that would render statements included in the prospectus or other offer documents to be misleading. That is consistent with the general purpose of the disclosure regime itself.

[87] We accept the submission made by Mr Carruthers QC on behalf of the Crown that, when the Judge referred to both the “accuracy and adequacy” of the information contained in the prospectus, he was doing no more than referring to the need to ensure that statements made in the prospectus were not false or misleading by the omission of material matters. In that sense, statements made in a prospectus could be inadequate as well as inaccurate.

[88] We are satisfied the Judge well understood that s 58 did not impose criminal sanctions on the basis of a general obligation to disclose material information unrelated to the accuracy of statements contained in the prospectus. That is clear from the whole tenor of his judgment and the identification of the three specific respects in which he found the statements in the prospectus were untrue through omission. In each case, the omissions related to statements already contained in the prospectus which the Judge found were misleading (and therefore untrue) in the absence of the omitted material.

[89] For example, although the amended prospectus referred to the risk of delayed loan repayments, it did not refer to the pattern of marked discrepancies between the company’s projections and the actual receipt of funds. And, in conveying an impression of the directors’ confidence about the ability of the company to repay investments when due, the amended prospectus omitted to mention the serious reduction in cash on hand and the directors’ concerns about that. While identifying potential risks, the prospectus did not bring home the imminence of them.

- 5.17 A similar view was taken by Heath J in *R v Moses*. The Crown case referred to a number of untrue particulars but also relied on the offer documents and advertisements “*read as a whole and the overall impression conveyed by them.*”¹⁰¹ Challenge was made based on fair trial principles, that an accuser had the right to know in detail what was being faced, and the Court ought not to go beyond the specific statements identified by the Crown. Counsel for the accused submitted it was impermissible for the Crown “*to seek to find a home for pure omissions by pointing to some oblique or distant or contrived relevance to an existing statement.*”¹⁰² Heath J stated:

[19] Section 55 of the Act is designed to provide a wider meaning to the word untrue than its popular use. For present purposes, the focus is on whether a relevant offer document is misleading ...

101 At [16]
102 At [17]

[20] When pressed, Mr Gedye accepted that some form of logical linkage between an omission and a particular statement might be appropriate, but he emphasised the element of proximity. While I accept the thrust of Mr Gedye’s submission based on the purpose of particulars, a narrow approach to relevant contextual evidence is unwarranted. Section 55(a)(ii) recognises that “suppression of the truth suggests the false.”¹⁷ A half truth can be as much misleading as a lie. If the absence of something material could lead an investor not to take account of factors relevant to an investment decision, s 55(a)(ii) will apply. The authorities make the obvious point that it is the overall impression conveyed by the offer document that is important, not a painstaking analysis of individual sentences contained in it.¹⁸

[21] It is true, as Somers J said in *R v Arnold (No 1)*,¹⁹ that the —object of particulars is to enable [an accused] to know fairly what he has to meet. However, there is no prejudice to an accused unless he or she were taken by surprise in answering the charges. In the course of a trial spanning some three months, there was no suggestion, at any stage, that the accused were surprised by the way in which the Crown put its case or that some other form of prejudice had resulted. While it is necessary for the Crown to be kept within the limits of its particulars, a relatively broad view of the contextual evidence is appropriate when considering the specific allegations of untrue statements.103

Overall impression conveyed by the prospectus

5.18 In *Moses Heath J* stated:104

The authorities make the obvious point that it is the overall impression conveyed by the offer document that is important, not a painstaking analysis of individual sentences contained in it.

He referred in support to some six authorities in England and New Zealand.105

5.19 Heath J, in his findings that in that case the investment statement and prospectus were materially misleading, further said:106

It is the combination of statements and material omissions that conveyed a false impression to investors about the true nature of

103 Footnote references in the judgment are

17 John Farrar and Mark Russell *Company Law and Securities Regulation in New Zealand* (Butterworths, Wellington, 1985) at 365, adopted in the *Agricola Resources* report, at para 9.8.

18 See *Peek v Gurney* (1872) LR 6 HL 377 (HL) at 386; *Arnison v Smith* (1889) LR 41 Ch D 348 (CA) at 369 per Lord Halsbury LC; *Aaron’s Reefs Ltd v Twiss* [1896] AC 273 (HL) at 281; *R v Kysant* [1932] 1 KB 422 (CA) at 448-449; *R v Rada Corporation Ltd* [1990] 3 NZLR 438 (HC) at 446-447 and *R v Rada Corporation Ltd (No 2)* [1990] 3 NZLR 453 (HC) at 474.

19 *R v Arnold (No 1)* [1977] 1 NZLR 718 (SC) at 721.

104 At [20]

105 At [20] fn 18

106 At [215]

Nathans' business, the actual state of its financial health and the risks of the investment.

- 5.20 Reference is also made again to Lord Halsbury LC's statement in *Arnison v Smith*¹⁰⁷ that, in regard to the expedient of cross-examining the person who has read a prospectus and asking him as to each particular statement what influence it had on his mind and how far it determined him to enter into the contract:

*This is quite fallacious, it assumes that a person who reads a prospectus and determines to take shares on the faith of it can appropriate among the different parts of it the effect produced by the whole. This can rarely be done even at the time, and for a shareholder thus to analyse his mental impressions after an interval of several years, so as to say which representation in particular induced him to take shares, is a thing all but impossible. A person reading the prospectus looks at it as a whole, he thinks the undertaking is a fine commercial speculation, he sees good names attached to it, he observes other points which he thinks favourable, and on the whole he forms his conclusion. You cannot weigh the elements by ounces. It was said, and I think justly, by Sir G Jessel in *Smith v Chadwick* that if the Court sees on the face of the statement that it is of such a nature as would induce a person to enter into the contract, or would tend to induce him to do so, or that it would be part of the inducement to enter into the contract, the inference is, if he entered into the contract, that he acted on the inducement so held out, unless it is shown that he knew the facts, or that he avowedly did not rely on the statement whether he knew the facts or not.*

- 5.21 This statement was referred to by Barker J in *R v Rada Corporation Limited*¹⁰⁸.

Untrue statements

- 5.22 The liability for untrue statements is imposed in s56, which provided, as at May 2004:

56 Civil liability for misstatements in advertisement or registered prospectus

(1) *Subject to the provisions of this section, the following persons shall be liable to pay compensation to all persons who subscribe for any securities on the faith of an advertisement or registered prospectus which contains any untrue statement for the loss or damage they may have sustained by reason of such untrue statement, that is to say:*

(a) *Where the issuer is an individual, the issuer of the securities:*

107 (1889) 41 Ch D 348 at 369
108 [1990] 3 NZLR 453 at 474

- (b) *In the case of an advertisement, every person who is a director of the issuer at the time that the advertisement is distributed or who has authorised himself or herself to be named and is named in the advertisement as a director of the issuer or as having agreed to become a director either immediately or after an interval of time:*
- (c) *In the case of a registered prospectus, every person who has signed the prospectus as a director of the issuer or on whose behalf the prospectus has been so signed, or who has authorised himself or herself to be named and is named in the prospectus as a director of the issuer or has agreed to become a director either immediately or after an interval of time:*
- (d) *Every promoter of the securities.*

What is a misstatement?

- 5.23 In discussing this issue Farrar & Watson refer¹⁰⁹ to the decision of the Court of Appeal in *R v Baxter*.¹¹⁰ The case involved an appeal against conviction under SA s58(3). The Court held that, in relation to a failed venture to recover gold from a wrecked ship, the fact that the prospectus had failed to disclose that the vessel to be used in the expedition was at the time still undergoing a refit and had yet to obtain its deep sea certificate was a “*piece of information*” that “*the recipients of the prospectus certainly needed in order to properly be able to assess the risk of investment*”.¹¹¹

Forecast financial information

- 5.24 Farrar & Watson refer¹¹² to the “*especially perplexing and related problem*” of forecast financial information. The text says that this goes to the heart of the dual function of a prospectus as simultaneously a selling and a disclosure document. A “blue skies approach” is likely to influence issuers seeking to sell the investment. At the same time there is a need for there to be disclosure of future financial information, particularly in the case of equity securities, for what is being offered for sale is a claim to future cashflows. “*But prospective financial information is inherently speculative and potentially easily manipulated*”.

109 At [34.6.2(1)]
 110 [1998] 3 NZLR 144 (CA)
 111 At [157]
 112 At [34.4.3(1)(b)]

Materiality

- 5.25 In 2002 the Securities Commission advised that “material” for the purpose of disclosure, means a matter that would be *“likely to influence a reasonable person in making a decision whether or not to subscribe for the securities without necessarily being determinative of the decision.”*¹¹³ Farrar & Watson consider that this is a reasonable summation of the existing law.¹¹⁴
- 5.26 In *Moses Heath J*, after considering a number of authorities in New Zealand, England and the United States, said:¹¹⁵

At the risk of adding a further phrase to the debate, if there was something that ought to have been disclosed that could well have made a difference to the decision whether to invest, it would almost inevitably be characterised as “material”.

Extent of disclosure

- 5.27 In *Graham Dobson J* did not consider¹¹⁶ that Heath J in *Moses* had set the bar for disclosure too high when Heath J had said¹¹⁷ *“The public rely on those responsible for making the offer to disclose everything of relevance that is likely to be material to the investment decision”.*
- 5.28 Dobson J said:¹¹⁸

If there is a statement or omission in relation to a point that is likely to be material to an investment decision then the prospect of liability should be triggered. That is the part that s58 plays in ensuring that those responsible for offering securities to the public discharge their obligation fully, to ensure that the market is indeed adequately and accurately informed.

Positive defences

- 5.29 Issuers, directors of the issuer and promoters are caught. However, the Act affords them the opportunity to prove positive defences.

113 Securities Commission *A Report on Aspects of the Initial Public Offering of Wakefield Hospital Limited in 2001* at [22]-[23]
 114 At [34.4.3(1)(a)]
 115 At [51]
 116 At [39]
 117 At [40]
 118 At [39]

5.30 Section 56(3)(c) confers a defence to civil liability under s56(1) for misstatements in a prospectus:

- (3) *No person shall be liable under subsection (1) of this section in respect of any untrue statement included in an advertisement or registered prospectus, as the case may be, if he or she proves that –*
- (c) *As regards every untrue statement not purporting to be made on the authority of an expert or of a public official document or statement, he or she had reasonable grounds to believe and did, up to the time of the subscription for the securities, believe that the statement was true;*

5.31 Section 63 provides for the Court to grant relief in certain cases.

- (1) *If in any proceedings against any person for negligence, default, breach of duty, or breach of trust in connection with—*
- (a) *An offer to the public or allotment of [securities; or]*
- [(b) *The distribution of a registered prospectus or [[advertisement; or]]]*
- (c) *The management of securities offered to the public; or*
- (d) *Any matter related thereto—*

it appears to the Court hearing the case that the person is or may be liable in respect of the negligence, default, breach of duty, or breach of trust, but that he [or she] has acted honestly and reasonably, and that having regard to all the circumstances of the case, including those connected with his [or her] appointment, he [or she] ought fairly to be excused for the negligence, default, breach of duty, or breach of trust, the Court may relieve him [or her] either wholly or partly from his [or her] liability, on such terms as the Court may think fit.

5.32 Factual issues in relation to the defences are dealt with more fully later.

However, at this stage the following comments can be made:

- (a) the burden is on each of the defendants to prove “reasonable grounds for belief”;
- (b) they have endeavoured to do so by focusing on the due diligence process adopted, yet have not called evidence from important persons involved. For example, evidence was not called from Ernst & Young nor those who actually undertook the modelling for the forecast and projection;
- (c) to focus on the due diligence process alone is too narrow an enquiry. Reasonable grounds for belief must be assessed against the totality of what was known or ought to have been known by the defendants, insofar as it is relevant to the IPO.

So seen it encompasses information (including short and long term patterns or trends) bearing on:

- (i) revenue from sales;
- (ii) volume of sales;
- iii) market share;
- (iv) whether budgets and forecasts had been and were being met;
- (v) competition, domestic and from overseas;
- (vi) tariffs and their historical effect;
- (vii) the nature and effectiveness of strategies and reviews thereof.
- (vii) the adequacy of the forecasting process

It should also involve an assessment of the defendants' knowledge of the likely audience for the IPO and whether the prospectus evidences the defendants seeking to set out in a way that communicates in a meaningful, effective and balanced way all information relevant to the current and future of Feltex.

- 5.33 To a significant extent the defendants, rather than placing openly before the Court such information as they had, or ought to have known, regarding such matters, left it to the plaintiff to introduce much material, presumably because it was unfavourable. This is not consistent with a positive defence that requires the Court to have regard to all circumstances,¹¹⁹ with an onus falling on the defendants.
- 5.34 As examples the defendants did not provide evidence showing how a six year decline in market share (as at FY04) was planned to be reversed, nor the steps if any taken by the defendants and the due diligence committee to provide reasonable assurance that the plan would and could be successfully implemented so as to achieve 1% growth in market share measured by volume in the year immediately following the IPO (FY05). Nor shown were the steps if any taken by the directors and the due diligence committee to satisfy themselves that substantial shortfalls in revenue and volume in April and May 2004 when measured against the forecast for FY04 and the previous year (and January and February 2004 measured against budget

119 SA 63 requires the Court to consider all of the circumstances.

and the previous year) did not signal problems, then or in the future. Instead, the focus of the Due Diligence Committee's brief consideration was on whether the shortfall should be disclosed, rather than the implications for the future. This was despite a prospectus that by including a projection for FY05 focussed significantly on the future.

5.35 In *R v Moses* Heath J observed that directors may delegate tasks to senior management:

Subject to adequate monitoring of management by the directors or anything that may put a director on notice of the need for further inquiry, reliance on information provided by management in their delegated areas of authority will generally be appropriate. **120**

In *Moses* Heath J considered all the information that the directors of Nathans had available to them prior to the issue of the prospectus, in particular Board papers. As to their defence of honest and reasonable belief in the truth of the statements in the prospectus, Heath J said:**121**

The problem for the directors ... is that they, in effect, purported to delegate to senior management the task of determining whether the investment statement and prospectus were "compliant" with regulatory requirements and failed to bring independent minds to bear on the topic.

5.36 Heath J further said:**122**

While it was fair for the directors to rely on the auditors to check aspects of the company's financial statements and to ensure that technical standards were fully met in relation to accounting policies, the accounts remained those of the directors and they had their own obligation to be satisfied of their content when signed.

Further:**123**

... a decision on the extent of disclosure on risk was for the board to make, not management

5.37 In *Graham Dobson* J was also required to assess the directors' defence of reasonable belief as to the truth of the contents of Lombard's prospectus. One of the grounds advanced was that matters of detail such as the relative reliability of projections on loan repayments from loan managers was a

120 At [82]
 121 At [420]
 122 At [422]
 123 At [423]

matter to be left to the directors and not appropriately addressed in the amended prospectus.¹²⁴ As to this, Dobson J said:¹²⁵

However, such an approach misunderstands the rationale for the disclosure regime. It is intended that investors be in a position to make decisions for themselves by being adequately informed on material matters, rather than making an investment decision in reliance on an assessment of the quality of judgement of those who would become custodians of their investments.

Further:¹²⁶

Mr Appleby did not consider that the extent of variance between projections relied upon by the Board from month to month and the actual outcomes, was a matter of interest to investors. Mr Appleby urged that changes were inevitable, and so long as the directors analysed the reasons for the extent of variances and accepted them as valid, then it ought not to be material to investors that variances had occurred. Again, that approach suggests that potential investors do not need to be told information that is relevant to an assessment of one important aspect of LFIL's business. In the circumstances of tightening liquidity generally in late 2007, investors were entitled to know the quality of performance by LFIL in managing its major loan exposure. One useful barometer of that level of success would be how accurately LFIL was able to predict the timing of repayment.

And further:¹²⁷

What is more relevant is the pattern of each subsequent months' projections all being substantially overstated to the point that a prudent evaluation of the cash flow forecast in December ought to have been acknowledged that they were unreliable.

- 5.38 Dobson J further referred¹²⁸ to the fact that the accused directors had confidence in respect of loan managers providing the forecast for loan repayments and that they considered that the loan managers had an established track record of expertise, and that the explanation provided by them for non-compliance with projections over the preceding months were reasonable. However, Dobson J said¹²⁹ that the accused's approach depended on their view that monitoring the accuracy of loan repayment projections was a matter of detail on which the investors would trust the directors' judgement:

124 Referred to by Dobson J at [108]
 125 At [109]
 126 At [110]
 127 At [111]
 128 At [125]
 129 At [126]

I do not find that a sufficient approach to justify the omission of any reference to the relative inaccuracy of such projections as “reasonable”. The timing of loan repayments was critical, and adequately informed investors could well take a different view from the directors about the extent of risk that arose from reliance on those projections. It was not reasonable for the accused to take the view that they could leave readers of the offer documents in the dark on that matter.¹³⁰

Dobson J further said¹³¹ that in relation to the omission in the prospectus of any reference to the trend of reduced cash on hand and the level of the accused’s concerns over liquidity:

Readers of the offer documents ought not to have been reliant on directors’ judgement on that matter, and I am not persuaded that it was reasonable for the accused to believe they could omit any such reference.

5.39 In the summary of his decision Dobson J held:¹³²

I am satisfied that readers of the offer documents in late December 2007 and thereafter would be likely to see the liquidity risk associated with investing in LFIL materially differently, if the extent of the company’s concerns, plus the downwards trend in cash and the extent of error in management projections of loan repayments, had been described to them.

5.40 In *Graham* Dobson J also referred¹³³ to the point that, in a negative sense, if the accused directly proceeded to issue offer documents whilst a professional adviser questioned the need for additional content, then that would adversely affect the reasonableness of their belief in the accuracy of the offer documents. Dobson J said:

I am not satisfied that the same relevance can be attributed in the positive sense to the absence of warning signals from competent external advisers, as supporting a positive finding that there were reasonable grounds for the directors’ belief in the accuracy of the offer documents. The directors’ obligations in relation to the accuracy of content of offer documents are non-delegable. As a matter of context, I accept that where LFIL retained competent outside advisers, respected their views, and completed the offer documents without those advising LFIL raising any relevant concerns, that it is marginally easier for the accused to make out reasonable belief. It would not, however, be sufficiently material to establish a basis for reasonable belief, if it did not independently exist.

130 At [126]

131 At [127]

132 At [328]

133 At [145]

5.41 In regard to reliance on management, Dobson J stated:**134**

The non-executive directors were unable to be specific as to how the loan managers were tested on the opinions they provided to the Board on the state of the loans. Particularly for Messrs Bryant and Jeffries, I find that their supervision did not extend meaningfully beyond an assessment of the attributes of the loan managers in the sense of asking how thoroughly they had reviewed matters material to their opinions and the managers' level of conviction supporting the views they expressed. The directors did not attempt to test the loan managers' opinions by any analysis of the risks of losses, that was independent of the information and advice received from the lending managers.

Further:**135**

By the time of the February 2008 Board meeting, the pattern of errors in the projections of performance by borrowers over the previous preceding six months should have caused the Board to question the adequacy of management of the major loans.

5.42 Heath J also referred to SA s2B and the Companies Act 1993 s138 as to reliance by a director on information from others, but noting**136** that both of those provisions envisaged the possibility of the need for further enquiry by a director, on the basis of information already held or incomplete information on which further explanation is required.

Who is a promoter

5.43 Common law definitions of promoter hark back to the 19th century, for example in *Twycross v Grant***137** as being “one who undertakes to form a company with reference to a given project and to set it going, and who takes the necessary steps to accomplish that purpose.”**138** and in *Emma Silver Mining Co Ltd v Lewis & Son***139** as involving the idea of “exertion for the purpose of getting up and starting a company”.**140**

5.44 There does not have to be only one promoter. For example, in *Official Receiver and Liquidator of Jubilee Cotton Mills Ltd v Lewis***141** it was held:

134 At [236]
 135 At [238]
 136 At [86]
 137 (1877) 2 CBD 469
 138 At 541
 139 (1879) 4 CBD 396 at 407; See also *Re The Great Wheal Polgooth Co Ltd* (1883) 53 LJ Ch42
 140 At 407
 141 [1924] AC 958 at 965

The leading part in the promotion of this company was taken by Hooley... But the fact remains that Lewis took part in the promotion. The part he played was, no doubt, subordinate to that played by Hooley but he acted on his own account, not as a servant or professional man. It appears to me impossible to frame any definition of the term 'single promoter' which would not include one who took the part which Lewis did in bringing this company into existence.

5.45 At common law those acting in a professional capacity were not generally regarded as promoters, although they could become so if they took on more than the role of a professional adviser.¹⁴²

5.46 Morison¹⁴³ notes (when dealing with the common law definition of promoter) that:

Solicitors, bankers, and printers, for example, whose only involvement is in drafting and preparation of the necessary documents on the instructions of others will not be promoters but the person who instructs a solicitor to incorporate a company is a promoter.

5.47 In *Australian Breeders Co-operative Society Ltd v Jones*¹⁴⁴ two people soliciting prospective investors in a business venture involving horse breeding syndicate were found to be promoters.

5.48 The common law definition has been superseded by the statutory definition, although Morison¹⁴⁵ notes that common law principles relating to the definition of promoter will continue to prove useful.

5.49 Promoter is defined in section 2(1) of the SA as follows:

promoter in relation to securities offered to the public for subscription,—

- (a) means a person who is instrumental in the formulation of a plan or programme pursuant to which the securities are offered to the public; and
- (b) where a body corporate is a promoter, includes every person who is a director thereof; but
- (c) does not include a director or officer of the issuer of the securities or a person acting solely in his or her professional capacity.

142 *Re The Great Wheal Polgooth Co Ltd* (1883) 53 LJ Ch42

143 At [8.2]

144 [1997] FCA 1405

145 At [8.3]

5.50 Morison¹⁴⁶ notes that the statutory definition is wide. The text states that it involves three aspects:

- (a) Was the person instrumental in the formulation of a plan or programme pursuant to which the securities were offered to the public (sub-para (a) of the definition);
- (b) If so then that person, and if it is a body corporate every person who is a director thereof (sub-paragraph (b)), is a promoter (sub-para (b) of the definition), subject to the exclusion in sub-para (c);
- (c) The exclusion of *“a director or officer of the issuer of the securities or a person acting solely in his or her professional capacity”*.

5.51 Submitted that sub-para (c) is not intended to capture body corporates, but only persons who are a director or officer of the issuer or who are acting solely in their professional capacity:

- (a) the exclusion in sub-para (c) uses the words, and is therefore directed at, a “director” or “officer” or a person acting solely in “his or her” professional capacity. These convey a personal concept;
- (b) that contrasts with sub-para (a) which refers to a “person” without qualification, which would include a body corporate;¹⁴⁷
- (c) that a body corporate falls within a person in s2(1)(a) is made express by subsection (b), which expressly references body corporates, and implicitly does so for the purpose of subsection (a);
- (d) there is no corresponding reference in subsection (c).

5.52 It is acknowledged that this interpretation would run counter to the principle that words within the same section generally bear the same meaning. However that general presumption can be displaced, and in this case is by the language used. A distinction as to the treatment of

146 At [8.3]

147 Interpretation Act 1999 s29, definition of a “person” includes a body corporate. However, s4(1) provides that the Act applies unless *“...(b) the context of the enactment requires a different interpretation”*

individuals and body corporates is apparent elsewhere in the Act, for example, the penalty regime in ss56 to 58 of the Act.

5.53 If sub-para (c) is given its broadest meaning then it is likely that significant categories of people would escape liability as promoter under the Act. For example, merchant bankers whose professional function may well be to raise moneys for a venture, incorporate and then list it, thereby undertaking the very acts that historically were undertaken by promoters. Such a broad definition would not sit well with the purpose of the Act as being for investor protection.

5.54 In *Graham Dobson J* referred to provisions in the offer documents that related to Lombard's liquidity risk. He said:**148**

I accept that the conditional language in which certain risks relevant to liquidity were described would reasonably have conveyed to readers of the amended prospectus that the directors were not concerned that the adverse circumstances described existed at the time, or were imminent.

5.55 Dobson J further stated:**149**

It is intended that investors be in a position to make decisions for themselves by being adequately informed on material matters, rather than making an investment decision in reliance on an assessment of the quality of the judgement of those who would become custodians of their investments.

And further:**150**

What is more important is the pattern of each month's projections all being substantially overstated to the point that a prudent evaluation of the cash flow forecasts in December ought to have acknowledged that they were unreliable.

5.56 As to the point that this would, in a commercial and marketing sense, mean that there was little point in issuing a prospectus providing cautionary information in this regard, Dobson J said**151** "*That consideration cannot influence the analysis of what was required to provide adequate and accurate disclosure*".

Reliance required by an investor

148	At [92]
149	At [109]
150	At [111]
151	At [122]

5.57 It is evident that the authors of Farrar & Wilson do not consider that reliance on specific statements in a prospectus is required in order to establish liability under s56. The authors discuss SA s55G,¹⁵² which is the section in the present Act which defines when a court may make a compensation order. The terms of s55G are materially the same as the former s56 in that this section refers to the court ordering a liable person (which is defined as in s56) to pay compensation:

...to all or any of the persons who subscribe for any securities on the faith of an advertisement or registered prospectus that includes an untrue statement, for the loss or damage that persons have sustained by reason of the untrue statement.

5.58 The text states that the key elements of s55G are that there is reliance on the prospectus (or advertisement) and that there is loss suffered. Under the equivalent section before amendment in 2006 (ie s56), the text states that expert opinion on whether reliance on the untrue statement is necessary, or whether it is reliance on the prospectus that is necessary, is divided. The common law required reliance on the untrue statement rather than the prospectus as a whole or the disclosure system evidenced by the prospectus. The text refers in this regard to *Boyd Knight v Purdue*¹⁵³. However, the authors consider that the plain words of s56 “*on the faith of ... the registered prospectus*” suggest that it is the prospectus, not the system of prospectuses, that the subscriber must have relied upon. The text says that this is broader than requiring reliance on the very statement and is consistent with the investor protection purpose of the SA. The text considers that this can be distinguished from the policy basis of the *Boyd Knight* decision where the auditor of the financial statements is too distant from the offering process to owe a duty to the subscribers and investors. The authors suggest, however, that a disappointed subscriber would need to show that he or she had read and considered the prospectus and that reliance on the system of registered prospectuses would not be sufficient, especially given that the process of registration is not a warranty as to accuracy of content.

5.59 The text then refers¹⁵⁴ to the decisions of this Court (French J) in *Houghton v Saunders*¹⁵⁵ and of the Court of Appeal in *Saunders v Houghton*.¹⁵⁶ The

152 At [34.6.2(4)(d)]

153 [1999] 2 NZLR 278 (CA)

154 At [34.6.2(4)(d)]

155 (2008) 19 PRNZ 173 (French J)

authors consider that *Boyd Knight* “can be readily distinguished from *Feltex*”. The words of the statute say in respect of issuers and their directors that liability exists when the investor subscribes “on the faith of the prospectus”. Directors and issuers are not auditors. Directors make the statements. The task, as against that of auditors, is quite different. The authors consider that Parliament said as much when it created a specific obligation on directors and issuers in s55G (noting that this is the same as the former s56). The authors express the view that the narrow limits on the common law negligence of auditors set by the Court of Appeal (in *Boyd Knight*) has little in common with the duty that Parliament has chosen to impose on those who approve and promote a float.

- 5.60 The text discusses ¹⁵⁷ the question how indirect can reliance on the prospectus be? It is noted that the answer to this question is somewhat confused by the existence of an investment statement. Since October 1997 the investment statement replaced the prospectus as the principal method of making an offer of securities to the public. An investor must receive an investment statement before subscribing for the securities. A registered prospectus is still required but there is no obligation for an investor to receive a prospectus. While most offers are made in a combined investment statement/prospectus (as in the case of *Feltex*), there is no need for an investor to ever sight a prospectus.
- 5.61 The text further says that if s55G were interpreted so that the investor had to have relied on the prospectus by at least receiving it or perhaps even reading it, an investor who had invested on the basis of an investment statement only would have no redress against the maker of a misleading statement in the prospectus. However, the text notes that the Court of Appeal (it is evident it is referring to the decision in *Saunders v Houghton*) seemed more attracted by an argument that the fact that the SA makes it possible to subscribe for securities without ever sighting a prospectus suggests that reliance on the fact of a prospectus may be enough to establish reliance for the purposes of s56. The authors state “*that argument appears plausible, particularly in the light of the broad investor focussed way the Act has traditionally been interpreted*”.¹⁵⁸

156
157
158

[2010] 3 NZLR 3321 (CA)
at [34.6.2(4) (d)]
at [34.6.2(4) (d)]

5.62 The text then discusses the fraud on the market theory adopted in the United States to establish the causal connection between the loss of value in shares and the misstatement made in the prospectus. It makes the point that the fraud on the market theory is predicated on the market in question being efficient. There are many necessary conditions for a market to be informationally efficient, but one of those is the number of competitive participants.

*“This is not the case in an Initial Public Offering whether it is done by the directors setting the price or via a book build process as happened in Feltex. Neither process is an efficient market such a market is not an efficient one, ie a market that can reasonably be presumed to reflect the impact of false statements in the market price of the securities”.*¹⁵⁹

5.63 As referred to in the opening for the plaintiff,**160** the Court of Appeal in *Saunders v Houghton* **161** signalled that s56 may refer to *“reliance generally on a prospectus rather than specific passages or figures”*.**162** A very narrow duty owed by auditors**163** has *“nothing in common with the duty owed by those who are a party to the issue of the prospectus”*, noting that the position of the vendor, the directors, the promoter and the organising participants and joint lead managers (ie in the present proceeding) is *“very different from that of the auditor, who has no role of promotion”*.**164** The Court of Appeal also referred to the fact that there is no longer a requirement under the SA for a prospectus to be made available to every potential investor. The offer to invest can be made in an investment statement which refers to but does not contain a copy of the prospectus. The Court said that this *“may be significant”* where an investor wishes to rely on an untruth in the prospectus but cannot claim to have read it.**165**

5.64 The Court of Appeal further said that if in truth Feltex was proved to be without substance there would be no need in a negligence claim to prove reliance of the kind required against auditors. The very float would contain an implied representation that the company had substance. To avoid being

¹⁵⁹ at [34.6.2(4) (d)]

¹⁶⁰ At [440]

¹⁶¹ [2010] 3 NZLR 331 (CA)

¹⁶² At [85] per Baragwanath J (for the Court)

¹⁶³ Referring to the appellant’s (ie the present defendant’s) reliance on *Knight v Purdue* [1999] 2 NZLR 278 (CA)

¹⁶⁴ At [87]

¹⁶⁵ At [88]

untrue the disclosure required in that case “*would need to be very explicit*”.**166**

- 5.65 The Court further said that it may be possible that indirect reliance may nevertheless be “*on the faith of a ... prospectus*” where “*that forms the basis of advice from a broker or news report*”.**167**

Securities Act 1978 s63A

- 5.66 The defendants claim that this section applies to the present proceeding and precludes the claim made by the plaintiff under the FTA from being determined by the Court against the defendants for conduct that is regulated by the SA if they would not be liable for that conduct under the SA. The plaintiff disputes this.

- 5.67 Section 63A was enacted by the Securities Amendment Act 2006, which came into force on 24 October 2006. It was therefore passed after the conduct giving rise to the alleged contravention of the FTA and the SA occurred and after the prospectus was registered and distributed. Accordingly, in terms for it to apply it would have retrospective effect, contrary to the Interpretation Act s7.**168**

- 5.68 Secondly, the transitional provision of the Securities Amendment Act makes it clear that it is not applicable to an existing contravention or commencing proceedings for an existing contravention or imposing any remedy in relation to an existing contravention.**169**

- 5.69 Under s24 an

“existing ... contravention” means a “contravention of the principal Act that was committed or done in respect of a prospectus that was registered ... before the commencement of this subpart”.

- 5.70 The reference to “*subpart*” is curious because the Securities Amendment Act does not have any subparts.

166 At [89]

167 At [91]

168 Section 7 provides: “*An enactment does not have retrospective effect.*”

169 Securities Amendment Act 2006 s24

5.71 The Fair Trading Amendment Act 2006 s5A came into force on 29 February 2008, which was three days after the present proceeding was filed. It would appear that Parliament’s intention was that neither amendment would apply until they had both come into force, although that is not directly relevant to the question of whether the amendments apply to the present proceeding.

6. Negligence

6.1 As stated in the plaintiff’s opening,¹⁷⁰ the fourth cause of action in 4ASOC alleging negligence against all defendants is essentially a claim for negligent misstatement under the rule in *Hedley Byrne v Heller*.¹⁷¹ The rule concerns negligent statements of fact or opinion inducing reliance by another person and resulting in that person suffering financial loss. The person making the statement will generally only be liable to persons with whom that person deals directly or for whom the statements made are specifically intended, and only in respect of known transactions. The burden of liability is accordingly rendered reasonably predictable.¹⁷²

6.2 The duty of care in words is said to be founded upon the speaker’s assumption of responsibility for what the speaker says. In cases involving non-disclosure of information or a failure to warn, there may be a duty to disclose or to warn if there has been a voluntary assumption of responsibility and reliance on the assumption.¹⁷³

6.3 The reference to “assumption of responsibility” recognises that a person owes a duty of care in tort because the law imposes the duty on the basis of what that person has said or done or has assumed to do, not because that person decides to assume legal responsibility.¹⁷⁴ In *Attorney-General v Carter*¹⁷⁵ the Court referred to this as a “*deemed assumption of responsibility*”.¹⁷⁶

6.4 Todd refers to when this will be considered to apply:

¹⁷⁰ At [445]
¹⁷¹ *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465 (HL)
¹⁷² Todd at [5.8.02]
¹⁷³ Todd at [5.8.04]
¹⁷⁴ Todd at [5.08.04]
¹⁷⁵ [2003] 2 NZLR 160 per Tipping J (CA)
¹⁷⁶ At [22]-[32] per Tipping J

The law would, however, deem the defendant to have assumed responsibility and find proximity accordingly if, when making the statement in question, the defendant foresaw or ought to have foreseen that the plaintiff would reasonably place reliance on what was said... The crucial question is whether a sufficiently "close" or "special" relationship between the defendant and the plaintiff can be established so as to justify the imposition of a duty.¹⁷⁷

6.5 Further:

A duty is commonly recognised where a skilled person acting in a strictly business context gives misleading information or advice directly or advice to another person, knowing the specific purpose for which the information is wanted and that that person attaches importance to and will rely on what that person hears or reads. In these circumstances there is foreseeable and reasonable reliance by a plaintiff who is in a close and proximate relationship with the defendant.¹⁷⁸

6.6 In *Carter Tipping J* further said that:

The ultimate enquiry is whether it is fair, just and reasonable to require the defendant to take reasonable care to avoid causing loss to the plaintiff.¹⁷⁹

6.7 Todd refers¹⁸⁰ to *Al-Nakib Investments (Jersey) Ltd v Longcroft*,¹⁸¹ which held that directors who issued a prospectus specifically to enable shareholders to consider a rights offer owed no duty to those who relied on the prospectus for the purpose of buying shares in the market. This approach was followed by French J in her judgment dated 8 June 2011 when striking out the causes of action brought by Mr Jones for purchasing on market in *Houghton v Saunders*.¹⁸²

6.8 Todd refers to the existence of a financial interest in the transaction in question has generally been regarded as sufficient in itself to attract a duty.¹⁸³

6.9 Todd discusses the claims under the FTA in relation to common law claims for misstatement, referring in particular to:

¹⁷⁷ Todd at [5.8.04]

¹⁷⁸ At [5.8.05]

¹⁷⁹ As stated in Todd [5.8.05]

¹⁸⁰ At [5.8.05]

¹⁸¹ [1990] 1 WLR 1390.

¹⁸² (2008) 19 PRNZ 173

¹⁸³ Todd at [5.8.06] fn 565, referring to a number of English, New Zealand and Australian decisions

- s9 lays down the required norm of conduct;
- it does not put any restrictions on the range or classes of person who can make a claim for its breach;
- there is no requirement that there should be a close “special” relationship between the parties;
- liability is strict and there need be no intention to mislead, nor need negligence be shown.¹⁸⁴

6.10 Todd states that, as might be expected, the statutory content for recovery of financial loss in negligence may be relevant.¹⁸⁵ A duty is more likely to be imposed if it would buttress and support the legislative policy, but denied if it would be likely to cut across or discourage performance of the statutory functions.¹⁸⁶ The text says that there are very many instances where the duty questions have been determined or have been influenced by the statutory context, frequently as tending to exclude but sometimes as tending to favour a duty.¹⁸⁷

6.11 In relation to omissions to act, the text states that a duty tends to be recognised in cases where the plaintiff reasonably relied on the defendant acting for the plaintiff’s benefit, or where the defendant exercised control over or assumed responsibility for the circumstances giving rise to the danger. The text further states that the elements of reliance, control and assumption of responsibility underlie various categories of cases concerning positive duties to act.¹⁸⁸

6.12 The first category dealt with is that of induced reliance. There may be a duty to act if one has undertaken to do so or induced a party to rely upon one doing so.¹⁸⁹

The pleading

6.13 The pleading at 4ASOC [85.1] – [85.2.7] alleges the basis for the duty of care owed, which it is submitted is fully in line with the principles expressed

¹⁸⁴ At [5.8.08(4)]

¹⁸⁵ At [6.6.02(5)], citing *Attorney-General v Carter* [2003] 2 NZLR 160 (CA)

¹⁸⁶ At [6.6.02(5)]

¹⁸⁷ At [6.6.02(5)]

¹⁸⁸ At [5.6.03]

¹⁸⁹ At [5.6.04]

above. This pleading relates to the basis for a duty of care owed by all the defendants.

- 6.14 The duty of care alleged is premised as being informed by the provisions of the Securities Act 1978, which had as its purpose investor protection through the disclosure of accurate and sufficient information so as to enable potential investors to make an informed decision on investments (at [85.1]).
- 6.15 In addition, further particulars are given as to the basis for the duty of care owed by the fourth defendant (First NZ Capital) and fifth defendant (Forsyth Barr). The particulars are the same, except additional allegations are made in respect of Forsyth Barr (at [85.22] and [85.23]).
- 6.16 At [86] the pleading alleges a sufficiently close relationship of proximity between each of the defendants and the plaintiff, as a potential investor in Feltex.
- 6.17 At [87] it is alleged that:
- the defendants assumed, or are deemed to assume, a responsibility for the control over the matters earlier pleaded (at 87.1));
 - reliance by potential investors was induced by the defendants (at [87.2]);
 - such reliance was foreseeable and intended (at [87.3]; and
 - each of the defendants (apart from Ms Withers) had a financial interest in the IPO and in maximising the amount of the final price for the shares (at [88]).
- 6.18 The grounds of negligence are the same as those alleged in respect of the roles and conduct previously pleaded in the negligence cause of action and in the ways previously pleaded in respect of the first and third causes of action under the FTA and SA. In respect of First NZ Capital and Forsyth Barr, negligence is asserted to be in respect of their role and conduct as previously pleaded in the negligence cause of action by promoting and marketing the prospectus which contained misleading statements and omitted material information.

- 6.19 All of the defendants were substantially involved in the preparation of the prospectus and in the IPO process. The submissions as to why the third – fifth defendants were promoters will be material in this regard, irrespective of whether they do or not satisfy the statutory definition of “promoter” or whether the exception in the definition for “professional advisers” is available.
- 6.20 The third defendant was represented in the IPO process by Mr Thomas (as well as the second defendant). All the defendants were involved in the due diligence process in either drafting or considering drafts of the prospectus as it developed. The second – fifth defendants each had specific roles referred to in the prospectus. The first – third defendants all signed the prospectus, as well as by each of the directors of the second defendant.¹⁹⁰
- 6.21 The defence in SA s63 is predicated on the basis that a person may be liable for “negligence” in connection with an offer to the public of securities or the distribution of a prospectus or the management of securities offered to the public or any matter related thereto.
- 6.22 Todd’s text indicates that the “but-for” test is the predominant test in tort for establishing cause in fact.¹⁹¹ If the plaintiff would have suffered the loss without (“but-for”) the defendants wrong doing then the wrongful conduct was a cause of the loss. The text states that the test tells us whether the conduct in question is a cause and that in many cases it is possible to give a competent answer to the but-for question and the inquiry into factual causation does not need to be taken any further.¹⁹²
- 6.23 The text then discusses cause in law. The ultimate question here is whether the defendant “*ought to be held to pay damages for the harm in question*”. Todd says that a helpful method in approach is to ask whether the plaintiff’s loss is within the scope of the risk created by the defendant’s conduct.¹⁹³

¹⁹⁰ Prospectus p 140

¹⁹¹ At [20.2.01]

¹⁹² At [20.2.01]

¹⁹³ At [20.3.02], citing *Bank of New Zealand v New Zealand Guardian Trust Co Ltd* [1999] 1 NZLR 664 per Gault J at 683; *Sherwin Chan & Walshe Ltd (in liq) v Jones* [2013] 1 NZLR 166 at [36-38]

C. THE EVIDENCE

7. Witnesses

Witnesses not called and information not provided

7.1 Absent from witnesses called by the defendants' were several advisers, including Ernst & Young. Their reports for the purpose of the due diligence process are thus hearsay and may not be relied on as evidence of the truth of their contents.

7.2 Also relevant to a reasonable care defence would be the information that was provided to Ernst & Young and the basis for their views. As was referred to by Heath J in *R v Moses*:¹⁹⁴

Professionals such as solicitors, accountants and valuers respond to instructions provided by a client. Clients instruct; advisers advise. The quality of any advice is only as good as the information provided to the professional, on the basis of which he or she is asked to advise. In considering the extent to which directors are entitled to rely on external advice, some assessment must be made of the prime information on which the advisor acted and whether he or she was on inquiry as to the accuracy of that information.

7.3 For example, were Ernst & Young provided with information and advice as to falling sales volume and value as at the time of the due diligence process, falling market revenue and increasing competition from Godfrey Hirst? Did they approve the final layout and presentation of financial information in the prospectus?¹⁹⁵

7.4 It is for the defendants to establish a reasonable care defence. Yet they did not give evidence of whether information such as that referred to above was provided to Ernst & Young. Nor the legal advisers. Nor did they call all of them as witnesses. Without hearing from them the Court cannot be satisfied that reliance on their reports was reasonable.

Reliability

7.5 It is clear that time has eroded the memories of quite a number of witnesses regarding events at Feltex dating back to 2000 to 2005, some 14 to nine

194 At [100]

195 The audit report of Ernst & Young as to the FY04 forecast and FY05 projections was limited to the matters referred to in sub-para (e) at p77 of the prospectus.

years ago. It is 10 years since the IPO and the issue of the prospectus. Memories have no doubt also been affected by discussion since then and, in the case of some of the first defendants' witnesses, the number of occasions on which they have recounted events.

- 7.6 Problems with recall were raised by several of the defendants' witnesses. Given the time that has passed that is not surprising in itself, but it is surprising that despite recall problems in many areas subject to cross-examination, most of these witnesses were able to assert strongly matters in their favour. They were also able to provide briefs of evidence of substantial length, even allowing for their reliance on contemporary documents.
- 7.7 Submitted that for non-experts the contemporary documentary evidence may well be preferred by the Court to oral evidence. This reflects the approach taken by Health J in *R v Moses*:¹⁹⁶

[112] I am satisfied that all of the directors attempted to give truthful evidence of what actually occurred. For understandable reasons, their recollections of events were, in some cases, imperfect. In the context of a detailed review of business activities from 2003 until August 2007, lapses in memories are to be expected. In a case like this, consistency with contemporaneous documentation is a better yardstick by which to measure the reliability of oral evidence. Oral evidence necessarily incorporates a degree of reconstruction. In addition, the nature of the human condition causes all of us to look back on past events on the assumption that we have always acted reasonably and responsibly, whether or not that is objectively true. I take those factors into account in assessing the reliability of evidence given by the directors and, indeed, other witnesses.

- 7.8 Turning to experts, significant attacks were launched on the credibility of the plaintiff's experts, for example Professor Newberry, on the basis, for instance, that she had been involved in judging a series of awards for poor company performance. Regardless of such matters, the relevance of which was peripheral, her qualifications and expertise stand, as should her evidence resulting from her application of that expertise.

8. Evidence

- 8.1 The defendants sought on a number of occasions to reduce the scope of evidence the plaintiff could rely on, and did so with some success. However, the proper evaluation of matters in issue in this proceeding requires an

196 At [112]

understanding of matters which give context to those pleaded.¹⁹⁷ It would be difficult to:

- (a) evaluate whether representations or statements made as to sales revenue (and a projected 1% growth in market share) were correct without reference to sales volume data, of which revenue is a function;
- (b) understand the appropriateness of disclosure of a risk or the assumptions which form the basis of the forecasts and projections without understanding the context;
- (c) understand whether Feltex's strategies were effective without knowing their success historically, for example as to Feltex growing its market share or otherwise;
- (d) evaluate the claim that Feltex was not a good investment without a broad range of evidence. The prospectus sold Feltex as a good investment based on a range of matters such as being a longstanding and successful company, increasing revenue, increasing market share by volume, passing on any raw material price increases and limited risk from tariff reductions. Evidence bearing on those matters upon which Feltex was so sold is relevant to an assessment of the truth of the relevant statement.

8.2 Having regard to such matters, submitted that evidence introduced by the plaintiff on a *de bene esse* basis should be admitted. That includes exhibit 5, the volume chart. It comprises a compilation of data taken directly from Feltex's records, with simple percentage calculations of a type that could be made as a submission. Submitted also that this chart was sufficiently adopted by witnesses to be admissible on the usual basis.

8.3 Submitted also that documents introduced by the plaintiff by being referred to in the plaintiff's opening, including the chronology, can be utilised, regardless of whether they were put to or adopted by a witnesses. In many instances witnesses did not specifically refer, when giving evidence in chief, to documents relied on in their briefs. Such a matter may go to weight, but not

¹⁹⁷ See in this regard what Heath J said in *R v Moses* at [20] – [21], referred to at para 5.17 above

admissibility. Moreover, as was apparent from the memory lapses of many of the defendants' witnesses, putting documents to them often served little useful purpose, apart from qualifying them under HCR r9.5(3).

- 8.4 Section D of these submissions is now turned to, the purpose of which is to provide the necessary evidential context, together with an overview of Feltex, the prospectus and reasons for Feltex's decline asserted by the plaintiff.

D. FELTEX

9. The company

Scope

- 9.1 Feltex was a manufacturer and seller of carpet, which until 2000 operated within New Zealand. In May 2000 it acquired Shaw Industries Australia, to become an Australasian company. At that stage its shares were held by Credit Suisse MP (the third defendant).
- 9.2 Its plans were to integrate Shaw Industries and thus both the Australian and New Zealand businesses. The integration of Shaw Industries resulted in some cost efficiencies, however the integration of the Australian and New Zealand businesses does not appear to have been fully completed by 2004.

Sales

- 9.3 Feltex sold approximately 80% of its carpet by value¹⁹⁸ (85% by volume¹⁹⁹) in Australia and most of the balance in New Zealand (a few percent were sold in USA). Feltex generally sold 70% into the residential (including apartments) market and 30% into the commercial market.²⁰⁰
- 9.4 It sold carpets made from wool but predominantly man-made fibre. As at early 2004 approximately 37.2% of Feltex's carpet sales volume were woollen and 62.8% were made of man-made fibre (synthetics). **201**

¹⁹⁸ Prospectus page 111 Segment information for period ended Dec 03 NZ \$78m, Aus \$133m USA \$2.6m Eliminations (\$42m) Net Total \$171m; after adjusting for 60% of NZ sales being export sales by Feltex New Zealand through Feltex Australia as per Magill BOE [30]

¹⁹⁹ DD1 000221. Management interview minutes of Des Tolan, CFO, on 2 April 2004. See Tolan BOE [32]

²⁰⁰ Magill BOE [38]

²⁰¹ DD1 000221. Management interview minutes of Des Tolan, CFO, on 2 April 2004. See Tolan BOE [32]

- 9.5 Feltex consistently measured its sales by both volume and dollars. Both measures are important. As stated, sales revenue is a simple function of volume times price.
- 9.6 Some carpet types resulted in a higher margin than others. In the lead up to the IPO Feltex was seeking to re-position its sales towards higher margin sales. It achieved some success in this, but submitted not as much as the evidence of some of the directors, Mr Magill (CEO)²⁰² and Mr Tolan (CFO)²⁰³ and other directors would suggest. By way of quantification, Mr Thomas gave evidence that that re-positioning resulted in an increased margin of \$4.7million for the half year to 31 December 2003 (compared to the previous year).²⁰⁴
- 9.7 At the time of the IPO, and beyond, the manufacture and sale of carpet made from man-made fibre comprised substantially the majority of Feltex's business, measured by both volume and dollar value.

Customer relations

- 9.8 As with any sales company, good customer relations are important. As will be referred to, those with a major customer, Carpet Call, were poor at the time of the prospectus, but this was not disclosed.

High break-even costs

- 9.9 The operating costs of a carpet manufacturer like Feltex are high. Substantial revenue is needed to cover those high costs, but once they are covered then good profits can be made. This was known to the Board.

Lean manufacturing

- 9.10 Those high break-even costs also meant manufacturing efficiency was very important. Over the period 2000 to 2003 Feltex sought to become a more efficient manufacturer of carpet by seeking to implement lean manufacturing principles. It engaged a leading lean manufacturing consultant, Dr John Blakemore, to assist it. Lean manufacturing techniques were partially

202 See Magill BOE [173]

203 See Tolan BOE [138] and Exhibit BB produced at NOE page 1544.

204 Thomas BOE [98]

implemented in this period. However (despite the representation in the prospectus), it is apparent there was much further work to do.

Raw materials

- 9.11 Feltex bought significant raw materials from overseas. The nylon for man-made fibre carpets was sensitive to the price of oil. Wool (from New Zealand) was subject to appreciation and depreciation.
- 9.12 By early 2004 the prices of both nylon and wool were appreciating, although they were still well below prices of only a few years previously.²⁰⁵ The prices were easily ascertainable.

Exchange rate

- 9.13 At all times Feltex was based in New Zealand. That exposed it to exchange rate risk. Changes to the NZ/AU cross-rate were especially significant, because Australian sales revenue, being the majority of Feltex's revenue post 2000, were reported in New Zealand dollars. This could have been quantified in the prospectus.

Tariffs and free trade agreements

- 9.14 Feltex operated in an industry that was subject to imports from overseas. Importantly, the tariffs on carpet in Australia were to reduce on 1 January 2005. Previous reductions had resulted in increased imports. This was apparent from historical data. **206**

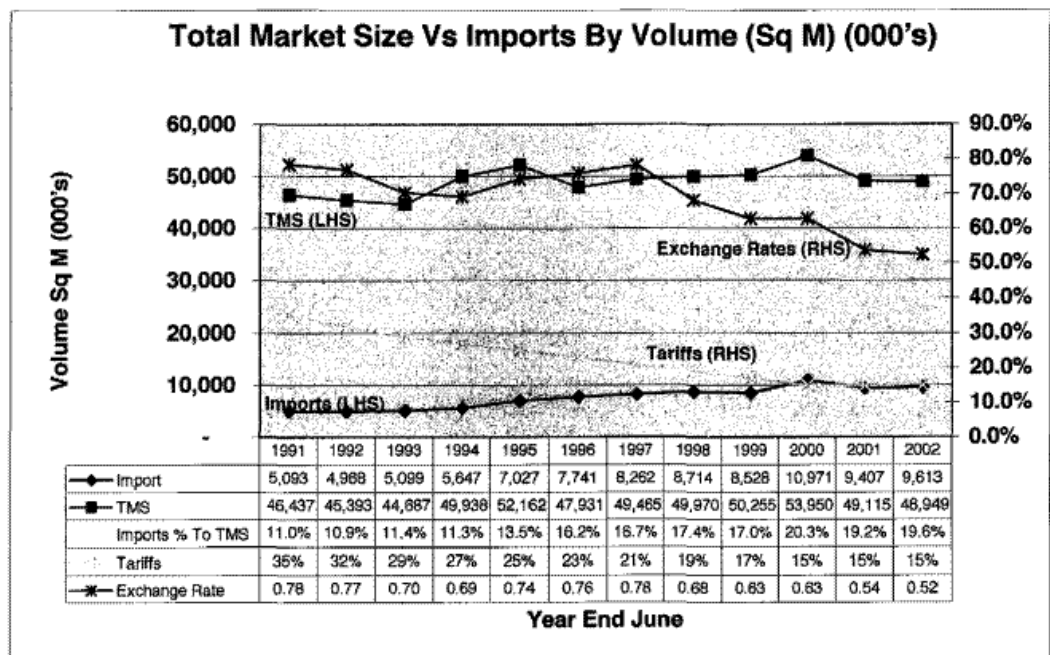
²⁰⁵

DD2 001002 @ 01021

206

CB4 003295 a@ 3303. See NOE (Thomas) page 1250, line 29

FELTEX AUSTRALIA PTY LTD



Source: Carpet Institute of Australia

- 9.15 This was further compounded by two free trade agreements with Australia coming into force in 2005. These were likely to increase the flow of imports into Australia.

Competition

- 9.16 Feltex operated in a very competitive environment, which would be aggravated by tariff changes and free trade agreements. In FY05 competition was claimed to be a significant factor for Feltex's poor financial performance that year.
- 9.17 Feltex's main competitor was Godfrey Hirst. It is clear from the Board minutes in February 2004 (and thus Due Diligence Committee) that it was engaging in increasing competition.

Cycle risks

- 9.18 Feltex was also known to be susceptible to economic cycle risks. Adverse economic conditions had contributed to the losses in FY01 and FY02. Positive conditions had contributed to a profit in FY03.

- 9.19 Such a risk is inherent in most businesses. Feltex was no exception. In a business described in the prospectus as being “*long-standing*” and having operated since the 1920s, such a risk occurring again in the future could reasonably be assumed to have been foreseen. When a prospectus touts strength, including strategic, as this did, such a risk can be assumed to be properly planned for. Yet, there is no evidence that Feltex did so, for example by having a forecast FY04 and projection FY05 that had “fat” such that they would be met if cycle conditions caused trading to fall. It did not have systems to enable rapid downsizing of operations and thus the reduction of the high-break even costs if conditions worsened.²⁰⁷

Profit volatility

- 9.20 Feltex had had a volatile earnings history. Its net surplus / (deficit) attributable to shareholders up until December 2003 (1HFY04) was:**208**

Year	Net surplus(deficit)(\$000)
July 1999 (12 months)	5,246
June 2000 (11 months)	2,607
June 2001 (12 months)	(13,181)
June 2002 (12 months)	(18,283)
June 2003 (12 months)	6,841
Dec 2003 (6 months)	11,414

- 9.21 A net deficit of (\$1.301 million) was impliedly forecast for 2HFY04, based on the forecast net surplus for FY04 \$10.113 million and the actual net surplus for 1HFY04 \$11.414 million.**209** This would be only the second year of profit in the last four years.

Risks

- 9.22 Feltex had to contend with the above factors. It is in fact incorrect to describe them as “risks.” They were adverse circumstances. The risk was that they might deteriorate, for example competition might increase. Disclosure was not required as to whether those circumstances might improve, but of what

²⁰⁷ CB 20 014401 @ 014405 –AGM break even @ 014406 – systems too rigid, & AF1 000011 @ 000018 – costs too high relative to competitors
 208 Prospectus p93
 209 Meredith BOE para 198

they were, what they meant, whether they might deteriorate, the risk of that and its likely effect. That is the required focus for sufficient disclosure.

- 9.23 A prudent Board of directors needed to consider and weigh each of the factors and risks, both individually and cumulatively. Cumulative consideration and weighing is necessary because of the potential for several risks to occur concurrently. For the same reason, an expert adviser upon whose advice a Board could reasonably rely would need to know about these adverse circumstances and also weigh them cumulatively.
- 9.24 As it happens, by February 2004 it was apparent that for several factors deterioration was occurring or was likely to occur concurrently. Raw material prices were increasing, import tariffs were being reduced on 1 January 2005, the Australia-USA and Thai-Australia Free Trade Agreements were coming into force on the same date, competition from Godfrey Hirst was increasing and the economic cycle had peaked or was peaking.²¹⁰
- 9.25 Those factors also had to be assessed against Feltex's ability to cope with them. That assessment necessarily required taking account of past performance and business factors such as Feltex's high-break even cost structure and its governance, staff, plant, operations and strategies. Again, the Board, Due Diligence Committee and relevant expert advisers relied on would need to be informed of and assess these factors.
- 9.26 It is only by undertaking a cumulative and contextual assessment that a meaningful appreciation of the factors, risks and potential could be obtained and conveyed to potential investors. Such an appreciation was not so conveyed, nor does it appear to have featured in the due diligence process. The prospectus does not meaningfully address cumulative risk despite the representation that Feltex was an excellent investment.
- 9.27 It follows that, without providing such information in the prospectus, prospective investors, both professional and retail, had to rely completely on the representations, assumptions, conclusions and opinions expressed in it. They were not given sufficient information to make any meaningful evaluation of the accuracy of the prospectus or the actual extent of risk.

²¹⁰ Refer paragraph 14.4

10. The Initial Public Offer

10.1 In mid to late 2003 Credit Suisse MP considered an IPO. The reasons for the timing of the IPO were, at least in part, set out in an email of 23 November 2003 from Mr Thomas to Credit Suisse, for whom he was also the Board representative and a consultant. It said in part:**211**

-----Original Message-----
From: Thomas, Peter
Sent: Sunday, November 23, 2003 5:53 PM
To: Dean, Tom; Millard, Ron
Subject:

Tom and Ron,

Quite a few developments that I need to update you on, and to get your directions.

Feltex.

I am getting a little more uncertain about the outlook for the Australian and New Zealand building cycles. We have all seen how sensitive Feltex is to this cycle, albeit that negative trends in Feltex's performance usually trail the downturn in the cycle by some 18 months. However, investors still understand this "trailing effect" having seen it in comparative industries with late cycle effects--eg, window suppliers, paint manufacturers. You may have seen that the Australian Reserve Bank recently raised their equivalent of the Fed Funds rate by 25 basis points (an anticipated rise) to 5.25%, and the RBNZ is making similar noises. These increases are in part targeted toward the "booming housing sectors" in both countries. Both countries are seeing a "topping off" in the applications for new commercial building permits. Feltex's order book is still incredibly strong and management believes that the Company will have a great year (EBITDA of over AUD 40 million), and is targeting achievement of the forecast for 2005 financial year (up a minimum of 15% on 2004.). However, when I observe these interest rate rises, and the building permit outlook, my concerns rise. I doubt that you (CSFB) want to ride out another down cycle before considering exit in an up cycle (usually a three to five year cycle). My doubts/concerns are "conservatively based" but I fear a slow down in these countries particularly if the US recovery does not maintain its outlook for 2004 calendar year. Confidence is a factor in Australia and NZ, and the US economy is a factor in confidence.

We remain in dialogue with Godfery Hirst about a strategic sale. I know of no reason why these discussions should not continue. However, I would recommend to you that we initiate discussions with First NZ Capital and Forsyth Barr

in NZ to prepare the way for an IPO in the second quarter of 2004 calendar year (being final quarter of 2004 financial year.) We can run parallel trade sale and IPO processes. This IPO would be undertaken on the basis of a projected 2004 FY result (which should be very certain come the fourth quarter of the FY), and a forecast 2005 FY result. I recently saw the CEO of Forsyth Barr who told me that in his view an IPO would achieve gross proceeds of 6.5 to 7.5 times 2005 EBITDA equivalent--which after fees would generate returns commensurate with a trade sale. It is interesting that three recent private company sales --exits by Private Equity funds--have gone the IPO route ahead of the trade sale route.

You will also have seen the strength of the NZ dollar. I am concerned at the holding power of this currency. CSFB's returns will be measured in USD and you will have seen a significant pick up in those proceeds as the NZD has climbed from 40 cents to 62 cents vs the USD over the last two years. Imports to NZ to compete against local production may occur in the high 60's. However, matching maximisation of proceeds from Company's performance with a stronger currency should see CSFB's returns maximised. Therefore, I think that we should look to a high degree of certainty of the sale of Feltex in 2004, through a trade sale or IPO.

There are some risks with an IPO which are not as apparent in a trade sale. It will embarrass the Firm if Feltex does not achieve the forecast, even if such failure is for the very best and most valid of reasons. If the general market crashes, and Feltex hits the forecast or suffers a fall in earnings in 2006, CSFB may be accused of "plucking the eyes out of the market" to the detriment of "Mum and Dad" investors. These issues should not arise in a trade sale. They may be more pronounced in a less sophisticated market like NZ, than in the US, particularly as this IPO will be very targeted to retail investors.

10.2 For the process of consideration for an IPO New Zealand First NZ Capital and Forsyth Barr were engaged. Their advice included that the listing should be on the NZX and that the shares would likely appeal principally to retail, as opposed to institutional, investors.

- 10.3 In early 2004 a decision was made to issue a prospectus and list on the NZX by way of an IPO. In March 2004 a due diligence process was commenced for that purpose. Feltex's Board (through the chairman, Mr Saunders) and the second to fifth defendants participated in the due diligence process. Credit Suisse was represented by Mr Thomas. Feltex's senior management was represented by Messrs Kokic and Tolan. First NZ Capital and Forsyth Barr were represented by observers, but that role included the ability to make inquiry. **212** Most of these were involved in the drafting of the prospectus and the IPO process.
- 10.4 The total number of shares to be issued depended on the demand and price. Credit Suisse MP offered 113.523 million shares to the public. Feltex offered a further 25.641 million to 29.411 million of new shares, the amount of which depended on the price, which was to be set by way of a book build process.
- 10.5 On 5 May 2004 a combined investment statement and prospectus was issued pursuant to the SA and Securities Regulations 1983. The closing date for the public offer, other than pursuant to firm allocations, was 21 May 2004. For applications pursuant to firm allocations it was 2 June 2004.
- 10.6 On 24 May 2004 Feltex (by its Chairman, Tim Saunders and its CEO, Sam Magill) announced that the issue price of the shares had been set at \$1.70 per share, with a projected dividend yield of 9.6%.
- 10.7 The many retail but relatively few institutional investors paid \$1.70 per share. Those who held bonds, which had been issued in 2003, paid 5% less. The directors and some senior management of Feltex paid a substantially lesser price, pursuant to an equity incentive scheme. It is unusual that a vendor shareholder, not the company would fund the purchase of those shares.
- 10.8 On 2 June 2004 the Due Diligence Committee approved and the Board of Feltex made a decision that the shares be allotted. Feltex had a market capitalisation of \$254 million, making it a major NZ listed company 10 years ago.

11. The drafting of the prospectus

- 11.1 The prospectus resulted from the combined efforts of those referred to above. The drafting process was overseen by the Due Diligence Committee. The JLMs, in particular, were actively involved with this.
- 11.2 That committee, and thus the defendants directly, or by being observers, could call for, receive and inquire into any relevant information. Any failure to call for relevant information and inquire into matters of which they (individually or collectively) were or should have been on notice about bears on the reasonable care defence.
- 11.3 There were three legal advisers, all of whom qualified their responsibility.²¹³
- 11.4 It is clear that final responsibility remained with the directors.
- 11.5 By the time the prospectus was issued on 5 May 2004 the Due Diligence Committee had met only four times. The remaining four meetings of the committee took place between 5 May 2004 and 2 June 2004.
- 11.6 There is no evidence that the Due Diligence Committee assessed Feltex's Group Trading Results, or the commentary on them in the Group Operating Reports, in particular for any of the four months from January – April 2004, nor the available detail for May 2004.²¹⁴ If it did, then such assessment is not apparent from the minutes of the Due Diligence Committee. **215**
- 11.7 The Board knew, or should have known, these results. They received monthly Group Operating Reports and Group Trading Results. Messrs Magill and Tolan, who received daily sales reports, certainly did.
- 11.8 The final meeting of the Due Diligence Committee on 2 June 2004 was the “bring down due diligence” meeting. Its purpose was to assess whether, since the date of the registration of the prospectus, there had been any material circumstances which would cause it to be false or misleading or if there were any material adverse circumstances which should be brought to the attention of the committee. It was considered there were none.

²¹³ These were Bell Gully (solicitors to the offer); Minster Ellison Rudd Watts (solicitors to the vendor); Herbert Geer Rundle (solicitors for Feltex's Australian operations).

²¹⁴ Sales detail was available from the daily sales reports.

²¹⁵ The limited discussion of a revenue shortfall at the 2 June 2004 Due Diligence Committee cannot reasonably be elevated to the level of a proper assessment.

- 11.9 The meeting of 2 June 2004 took place by telephone conference and is recorded in the minutes as taking only 45 minutes starting at 7 am.²¹⁶ There is reference to a relatively brief discussion with Messrs Magill and Tolan about a shortfall in the forecast sales for FY04. However, the committee did not consider or request any other specific information in this regard. It did not make or require to be made any inquiries beyond that meeting. It did not seek other advice. The possible effect of what it was told as to the sales shortfall in the FY04 forecast on the FY05 projections was not specifically considered.
- 11.10 Consequently, the view having been taken at the meeting that there was nothing further that was material, the forecast for FY04 and projections for FY05 remained unaltered.
- 11.11 There was no further disclosure to the market. The prospectus remained unaltered. The IPO closed and the shares were allotted that day. Feltex shares began trading on the NZX on 4 June 2004.

12. The prospectus

- 12.1 Potential investors who read the prospectus will logically start at the early stages, and read those before delving elsewhere, as was clear from Mr Gailbraith QC's questions in cross-examination to Mr Houghton and his response²¹⁷
- 12.2 The early parts of the prospectus paint a very rosy picture of Feltex. These include its *"Key Investment Features"* (p7), *"Key Statistics"* (p9), *"Summary pricing table"* (p11), *"Letter from the chairman"* (p13), *"Investment features"* (pp15-16), *"Business description"* (pp41-51), *"Directors"* (p53) and *"Feltex management"* (p63), accompanied by a variety of enhancing images.
- 12.3 Bolded, coloured statements such as those on page 7: *"Feltex Has A Long-Standing And Successful Operating History ... With A Number Of Sustainable Operational Strategies Now Successfully Implemented ... Positioning Feltex As A Responsive-Service Orientated Manufacturer of Significant Scale ... With Excellent Investment Features – Solid Core Earnings And Potential For Further Earnings Growth"*, plus the statement

²¹⁶ DD2 000751

²¹⁷ Houghton NOE 72 lines 26 - 30

that “*Feltex has been operating in New Zealand since the 1920s, and is now one of the two largest Australasian carpet manufacturers ...*” convey an impression of a strong, well resourced and well run company which has excellent prospects for future earnings growth. These were all statements as to Feltex’s present position, including that referring to its potential for further earnings growth.

- 12.4 Supporting this very positive impression, Feltex’s corporate governance and senior executives are described favourably.²¹⁸ The directors are presented as astute, experienced and wise business people, with the industry and economic knowledge, skills and expertise to progress Feltex’s growth.²¹⁹
- 12.5 Audit and Risk Management, Finance, Occupational Health and Safety and Remuneration Committees are described.²²⁰ (Notably, no evidence has been given by the defendants as to those committees’ roles in the IPO, in particular whether the Audit and Risk Management and Finance Committee had any separate role in the scrutiny of the prospective financial information, risks and assumptions.)
- 12.6 Senior management were also represented as being experienced and capable.²²¹
- 12.7 The financial information presented in the early parts of the prospectus adds to that impression. The “*Summary Financial Information*” on p19, for reasons that remain unclear from the evidence, fails to provide details of the “normalised” NPAT for FY02 and FY03. No actual NPAT figures for these years are provided either.
- 12.8 While the actual NPAT, and thus the fact of substantial losses for FY01 (\$13,181,000) and FY02 (\$18,273,000) are available on p93, readers are not directed there by either p19 ²²² nor the “*Important information*” section on p1.
- 12.9 Some adverse historical information is also available on pages 81 to 83 “*Management discussion and analysis of financial result*”. However, again

218 Prospectus p58; pp53-57

219 Prospectus pp 53-57

220 Prospectus pp58-59

221 Prospectus pp16, 63-66

222 A footnote on p19, in very small type, advises readers that “...*further information on the forecast 2004 and projection 2005 ...*” is available on “... *pages 85 to 92...*”. There is no reference to the summary of historical financial information on p93.

readers are not directed there on p19. Moreover, and peculiarly, that part, while referring to Feltex's performance in 2001 and 2002, does not actually identify the losses (NPAT deficit) that occurred in those years. The matters detailed there, for example decreasing sales revenue, are explained being largely as being attributable to one-off types of event. The prospectus does not arm the prospective investor with information to enable those explanations to be assessed.

- 12.10 In short, the first impression is overwhelmingly positive. As stated by Heath J in *R v Moses*:

"The authorities make the obvious point that it is the overall impression conveyed by the offer document that is important, not a painstaking analysis of individual sentences contained in it." **223**

13. Financial performance post - IPO

- 13.1 The prospectus contained forecast and projected financial performance as follows: **224**

Year	Net surplus (\$000)	Revenue
FY04	10,113	335,498
FY05	23,899	348,147

- 13.2 This did not reflect actual events. By May 2004 both sales revenue and sales volume were down against forecast ²²⁵ and, as well, against budget and compared with the previous year by significant amounts.

- 13.3 These were known before the allotment of the shares on 2 June 2004 but not disclosed to the market at that stage. The shortfalls clearly signalled that failing to meet the FY04 sales forecast of \$335,498,000 was unavoidable.

- 13.4 The situation did not improve in FY05. The projected revenue of \$348,147,000 and the "normalised" projected FY05 NPAT of \$25.9 million

223 At [20]
 224 Prospectus p85
 225 Paragraphs 19.16 – 19.27 of these submissions

- 226** were necessary in order to enable the projected dividend yield to be achieved. Neither were met.
- 13.5 By 31 December 2004, only 6 months after allotment, Feltex was behind the projected revenue target for the 1HFY05 by \$21,253,000²²⁷. Sales volume had continued to fall against both the projection and the previous year.²²⁸
- 13.6 Despite that, on 23 February 2005 Feltex announced an on track interim result for 1H FY05 (six months ended 31 December 2004). The net surplus was said to be up 7.1% on the previous corresponding period.²²⁹ An interim dividend of 6c/share was announced, which was 15.4% above the projection in the prospectus. Such an optimistic approach to the interim dividend was surprising in light of Feltex's actual performance and was symptomatic of the directors' unrealistic approach.
- 13.7 The decline in sales volume continued, as did a decline in revenue. On 1 April 2005, only 10 months after the closure of the IPO, Feltex announced a substantial profit downgrade from that projected for FY05 in the prospectus.²³⁰ . On 13 April 2005 Feltex made a further NZX announcement that its third quarter result for the three months ended March 2005 was a net deficit of \$888,000.00 after tax.²³¹ . On 20 June 2005 Feltex announced a further profit downgrade, of less than half the FY05 surplus (NPAT) projected in the prospectus.²³² On 24 August 2005 the directors reported audited earnings for FY05 of \$14.1 million (55%) less than the net surplus projected in the prospectus.²³³
- 13.8 From 2 June 2005 onwards the Feltex directors resigned. Mr Magill's employment as CEO was terminated, with effect immediately, on 27 September 2005, although it had been announced in June 2005 that this was to occur in December 2005. He was also asked to resign as a director.

226 This is the "normalised" NPAT in the prospectus p19 which provides the basis for the stated 9.6% gross dividend yield

227 CB13 009725 'NZD Fcast P&L Input'; BP6 005040 at 5090. See NOE (Horrocks) pages 2358 - 2360

228 CB13 009725 'NZD Fcast P&L Input'; BP6 005040 at 5090. See NOE (Horrocks) pages 2358 - 2360

229 CB18 013345

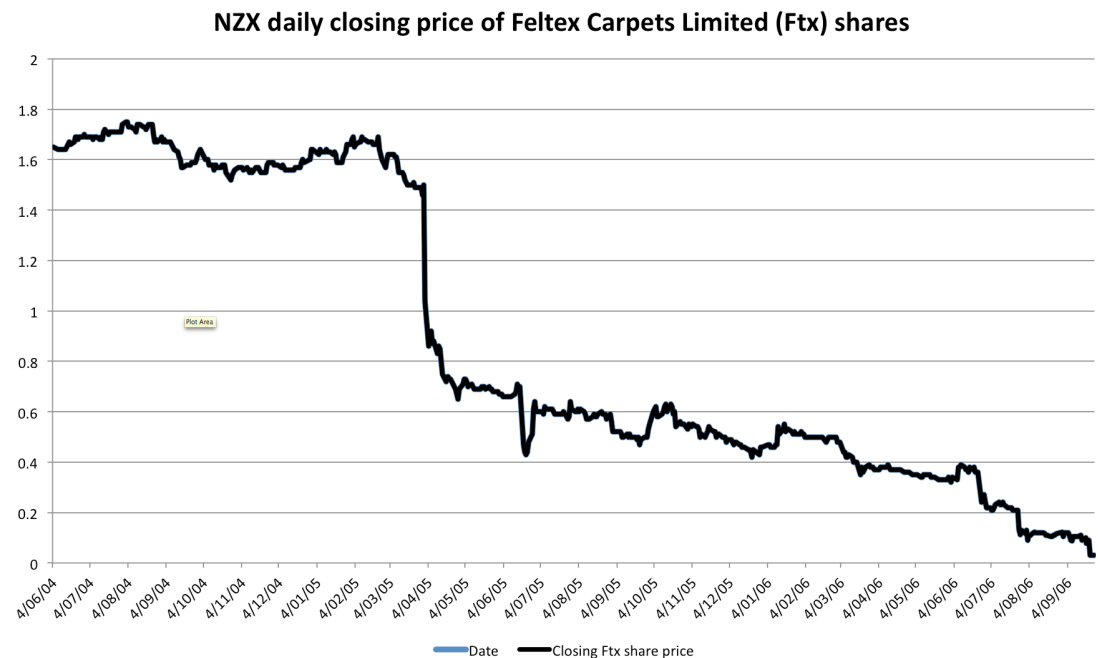
230 CB18 013422

231 CB18 013438

232 CB19 013804

233 CB19 013887 @ CB013906 & CB013927

- 13.9 On 22 September 2006 Feltex's bank, the ANZ Bank, appointed receivers. In October 2006 the receivers sold the New Zealand and Australian assets of Feltex to various entities of the Godfrey Hirst group, a substantial carpet manufacturer primarily based in Victoria, Australia.
- 13.10 Since listing the shares had failed to appreciate to any real extent. From 1 April 2005, after the profit downgrade announcement, through to September 2006, their price declined substantially from near the issue price to being virtually worthless. Shareholders did not recover anything as a result of the receivership and sale of Feltex's assets. The share price is shown in the below chart:²³⁴



14. The reasons given by the directors in 2005

14.1 In summary thus far, Feltex's performance was not as forecast, projected or represented. It did not:

- (a) meet its forecast sales volume for FY04. That was a continuation of a trend of not meeting budget, previous year and forecast;

²³⁴

Data has been taken from the NZX data records. For consistency, the daily closing share price has been used.

- (b) meet its projected sales volume and revenue for FY05. Again, that was a continuation of the same trend;
- (c) grow its market share in FY04 or FY05. That was a continuation of the trend of its market share reducing.²³⁵

14.2 Feltex, at the time, and some of its directors in evidence advanced a range of reasons for the decline in its fiscal performance, including a worsened economic environment, an increasingly competitive price environment, due to increased synthetic imports and issues within Feltex.

14.3 The 1 April 2005 downgrade said that the key reasons for the revised and substantially reduced sales and net profit projections included the factors just referred to and, as well:

- a. The current shortage of laying contractors; and
- b. Continued low store traffic advised by key residential retailers;

We have experienced increased price competition in the market primarily due to synthetic imports being higher than projected (due to the strength of the A\$ versus the US\$);
- c. Inability to pass on synthetic raw material cost increases; and
- d. The inability for Feltex to reach its projected market share increases due to the reduction in the local Australian manufacturers' share of the market due to rising synthetic imports; and
- e. The slowing Australian residential market and the ongoing strength of the New Zealand dollar;
- f. The 20 June 2005 profit downgrade (which also announced that Feltex was making senior management changes and undertaking a wide ranging review of its operations) referred to;
- g. Further tightening of market conditions, average selling prices and margins in Australia being likely to be lower than anticipated previously;

²³⁵ CB11 007831; BP7 006296 at 6383 (Chronology).

- h. The New Zealand residential market having started to soften, competitive conditions in Australia (79% of the company's sales ²³⁶) having continued to intensify;
- i. The continuing strong NZ and Australian currencies against the US currency having resulted in imported carpet becoming more competitive; and
- j. Significantly, stating that:

The market share of imports in Australasia has risen from 14.5% to 17% for the 12 months to 31 March 2005.

- 14.4 There is evidence of worsening economic conditions in Australia in early 2005. However, that conditions could change sometime was clearly foreseen by the JLM's. FNZC and Forsyth Barr in their presentation 19 April 2004 ²³⁷ note the negative influences that have arisen.

Weaker and more cyclical outlook beyond FY2005 than previously assumed

- *Significant market down turn forecast by BIS Shrapnel in 2007*
- *Raises concerns over sustainability of FY2005 earnings and further growth potential above this level*

The Westpac – Melbourne Institute Consumer Sentiment Index March 2004 ²³⁸ presented to the 1 April 2004 board meeting showed:

- *The Westpac - Melbourne Institute Consumer Sentiment Index fell by 3.8 per cent in March*
- *The fall in sentiment in the latest month occurred despite the Reserve Bank's decision in early March to leave official interest rates unchanged*
- *The ongoing strength of the Australian dollar, however, would appear to be dampening inflationary pressure associated with a buoyant economy*

²³⁶ CB 19 013923 2005 Annual report segment information – New Zealand \$133m, Australia \$233m, USA \$5m, Eliminations (\$77m) Net total \$294m

²³⁷ CB10 007535 @ CB--7540

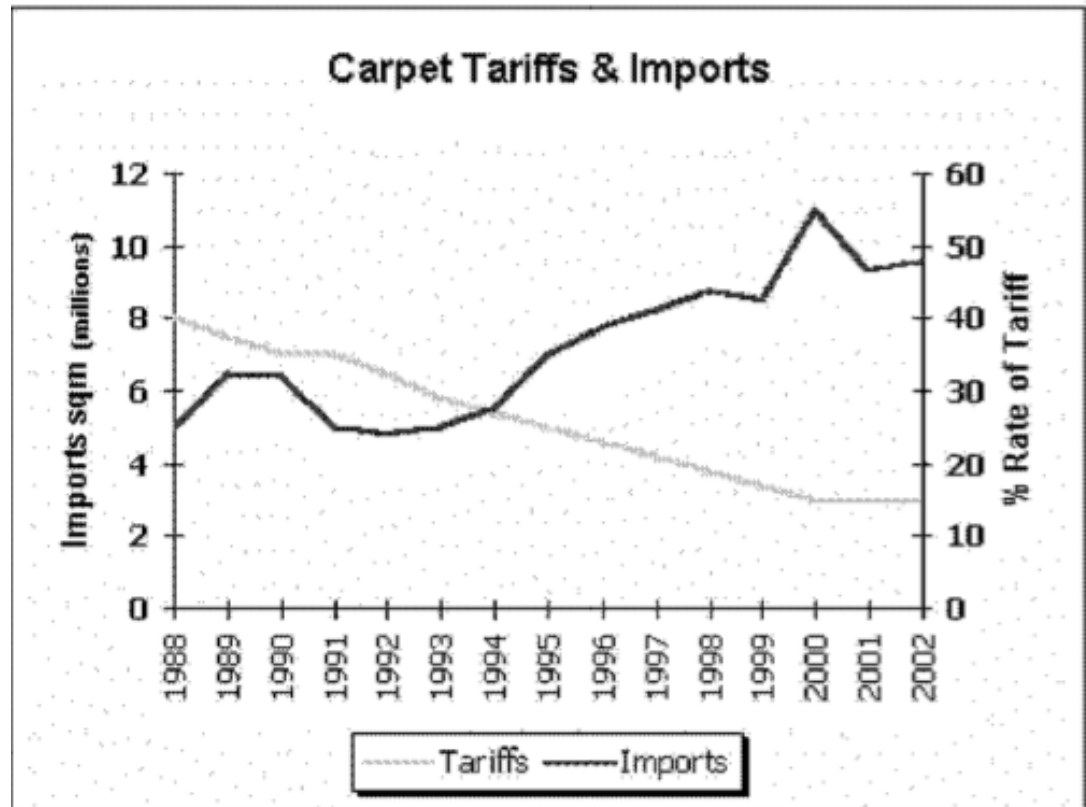
²³⁸ BP4 003512 @ BP003650

- *Clear signs that the housing market is slowing*
- *Falls were recorded in all five component indexes of consumer sentiment*
- *The biggest fall was in the index reflecting the outlook for family finances down by 6.5 per cent.*
- *Falls in the indexes reflecting the 12-month and five year economic outlook, both down by 4.0 per cent.*
- *The index reflecting the state of family finances compared to a year ago fell by 3.3 per cent following a sharp rise in February.*
- *The index reflecting whether or not it's a good time to buy major household goods fell by 1.5 per cent.*
- *Interest rates continued to be by far the most recalled news item in the latest month, with recollections more often than not unfavourable.*

14.5 The consequential effect on share price of the 1 April 2005 profit downgrade and subsequent market analysis can be seen from the FTX share price chart at paragraph 13.10.

14.6 It would be surprising if the circumstances underlying those reasons were only able to be known in retrospect. For example the impact of tariff reductions was available from longitudinal data.²³⁹

²³⁹ CB 4 033352



14.7 There is evidence of worsening economic conditions in Australia in early 2005. However, that conditions could change sometime was clearly foreseeable, the issue was only one of timing. Before the IPO Mr Thomas had foreseen a likely change in economic cycle²⁴⁰ and the Group Operating Reports recorded certain markets had peaked peaked²⁴¹

14.8 Instead, all Feltex really did in FY05 was continue its previous volatile performance and declining sales trend, albeit at a greater rate.

E. THE CLAIMS

15. The statement of claim

15.1 Criticism has been directed at 4ASOC, in particular for being diffuse. While it is accepted that it is complex, it is apparent from the defendants' statements

²⁴⁰

CB7 005377

²⁴¹

BP4 003512 at 3596 "Trend Analysis: A short term trend analysis (Le. the last 12 months) shows that residential new building activity has reached its peak. (Refer Figure 1)The long term trend analysis for residential new building consents also shows activity has reached its peak. (Refer Figure 2)"

of defences, mini-openings and openings, and the evidence called and cross-examination by the defendants that they are in fact well aware of the issues in the proceeding.

15.2 Key features of the 4ASOC include:

- (a) paras 1 to 6 which deal with the roles of the parties;
- (b) paras 18 and 19 and Schedule 1 (extracts from the prospectus), which set out statements and information in the prospectus that are alleged to be misleading. The defendants admit the existence of those statements but deny they are misleading and rely on the full terms of the prospectus.²⁴² The plaintiff likewise relies on the full terms of the prospectus.
- (c) para 32 alleges that the defendants were in trade and as such engaged in conduct in terms of FTA s9 that was misleading or deceptive or likely to mislead or deceive;
- (d) para 33 sets out three ways in which the statements were misleading, and is followed by more detailed pleadings and particulars at paragraphs 34-72. Those three ways are:
 - (i) the statements and information contained in paragraphs 18 and 19 of 4ASOC were incorrect, likely to lead potential investors into error or mislead them and conveyed a misrepresentation;
 - (ii) the correct position was not disclosed in the prospectus when many of the facts were known or ought to have been known;
 - (iii) the prospectus contained the errors then pleaded and they remained uncorrected up to the date of allotment.

15.3 The various claims are then repeated in the claims under the SA (paragraphs [81] to [83.3]) and in negligence ([84] to [90.3]).

²⁴² 1 D, SOD 30 September 2013, para 18; 2 and 3 D, SOD 27 September 2013, para 18; 4 D, SOD, para 18; 5 D SOD para 13

15.4 There is a separate cause of action (the second) against Mr Magill under the FTA (paras [77] to [80]).

15.5 Paragraphs [9], [17.6], [19], [73] – [74] and [85.3 – 85.38] relate to the JLMs.

16. The parties

Roles under the Securities Act 1978

16.1 The first defendants were the directors at the time of the IPO. They each signed the prospectus.²⁴³

16.2 With the exception of Joan Withers, they had all been appointed for several years and can be assumed to have significant knowledge of Feltex. Ms Withers was appointed only a short time before the IPO and would have had lesser knowledge.

16.3 The second defendant, Credit Suisse PE, was the named promoter in the prospectus. It controlled Credit Suisse MP. This is accepted.

16.4 The third defendant, Credit Suisse MP, was the vendor and an issuer of Feltex shares. This is accepted. It is alleged but denied that it was also a promoter.

16.5 The fourth defendant, First NZ Capital, was a JLM and organising participant of the IPO. It is also alleged to be a promoter, which it denies.

16.6 The fifth defendant, Forsyth Barr, was also a JLM and organising participant of the IPO. It is also alleged to be a promoter, which it denies.

Fair Trading Act 1986

16.7 The plaintiff alleges the defendants were each carrying on business in trade for the purpose of the FTA.

Negligence

16.8 The plaintiff alleges each defendant also owed a tortious duty in negligence to the plaintiff and the qualifying shareholders.

²⁴³ Prospectus, page 2

(I) ISSUES WITH FELTEX

17. Sales revenue

Introduction

- 17.1 This is the first of four topics that deal with actual and prospective sales: sales revenue, sales volume, the forecast FY04 and the projection FY05. Although they are dealt with separately, they are inextricably intertwined and are intended to supplement each other.
- 17.2 For example, revenue is a function of sales volume and price. They form an integral part of the forecast FY04 and projection FY05. They are an integral part of the pleadings that attack Feltex's represented profitability, the forecast FY04, the projection FY05 and whether Feltex was a good investment.

Pleadings

- 17.3 Sales revenue forms a part of various pleadings:
- 34 Schedule 1A, prospectus pg 7, was misleading as to reasons why Feltex was a good investment based on trading history and existing and potential earnings;
- 37 Schedule 1C, prospectus pg11, was misleading because the FY05 NPAT of \$25.9 million was not reasonably achievable or likely to be achieved nor was the indicative price earnings ratio (pre-good will amortisation) of 9.8 to 11 times reasonably achievable or likely to be sustained;
- 42.2.1 The prospectus was misleading in failing to disclose that Feltex's *"sales, margins and profits for the period ended 31 December 2003 would not be, or was unlikely to be, sustained for the period 1 January 2004 – 30 June 2004. (They were not in fact sustained)"*;
- 44.1 Schedule 1K, prospectus pg 85, was misleading because the projected net surplus for FY05 was not reasonably achievable or likely to be achieved;
- 44.2 Schedule 1K, prospectus p85, was misleading because the projected revenue for FY05 and net profit had never been achieved in any year

from 2001-2004 and Feltex's reported revenue had increased for the first time since 2001 only in 2004;

- 59 The prospectus did not disclose that Feltex had a high break-even cost structure;
- 64.1-3 The forecast FY04, prospectus pp19 and 85, was misleading because the directors, Credit Suisse PE and Credit Suisse MP, knew at the time of allotment that there would be a shortfall against sales revenue of \$7.5 - \$9 million;
- 64.6 The projection FY05 pp19 and 85 was not capable of being met because of factors that include the declining trajectory of operating revenue from sales for FY2002-2003.

Sales revenue was important

- 17.4 It is axiomatic that sales revenue and trends in sales revenue are important in a company whose raison d'être was to sell carpet and increase market share.²⁴⁴ Their importance was reflected in a number of ways. Sales revenue was the primary source of operating revenue and thus a key measure of past and indicator of future performance. It is the top line of the statement of financial performance and was monitored by the Board, who received sales information monthly by way of Group Operating Reports. Those reports commenced with a table of financial performance, followed by a commentary that dealt with "volume", followed by "sales dollars" (revenue), "margin dollars" and then "margin percentage."²⁴⁵
- 17.5 Revenue featured prominently in the prospectus. Examples include
- page 7 (Schedule 1A): *"The successful implementation of these strategies and initiatives provides Feltex with an excellent earnings base and competitive position. Feltex now has the infrastructure, manufacturing capacity, cost base and marketing strategies in place to capitalise on market opportunities and support further revenue and earnings growth."*; and

²⁴⁴ Russell NOE 1090 line 11 " A mature company with a decreasing sales is a concern to anyone."

²⁴⁵ An example is the Group Operating Report for January 2004, BP4 003218 @ 003228

- page 13 (Schedule 1CC) being the letter from Mr Saunders, which uses phrases such as Feltex being a *“long-standing and successful manufacturer”*, the *“achievement of Feltex’s current level of sales²⁴⁶ and profitability”*, *“continue to grow the Feltex business”* and *“Driving future growth and earnings”*.

17.6 Page 15 includes that

“Feltex manufactures over 17 million square metres of carpet per annum²⁴⁷ and has annual sales of over \$310 million”; and

page 16 (Schedule 1 D)

“Feltex now has the infrastructure, manufacturing capacity, cost base and the following key strategies in place to capitalise on market opportunities and support further revenue and earnings growth.”

17.7 Revenue necessarily features in the financial data. The Summary Pricing Table (Schedule 1C, prospectus pg11) projects NPAT for FY05, a result reliant on sufficient revenue. That is apparent both as a matter of common sense and from note 1 that states that the figures in the table are derived from the information set out on pages 85 to 92. The top line of the consolidated statement of prospective financial information (Schedule 1K, prospectus p85) is

- *“Total operating revenue.”* **248**
- The *Summary Financials* (Schedule E, pg 19) commences with the *“Total operating revenue”*.
- The *“Business description”* (Schedule 1 I) refers to *“having “successfully implemented” sustainable operating strategies that have “positioned Feltex as a responsive manufacturer of high quality carpets with an excellent platform for further earnings growth.”*

246 *“level of sales”* likely means the volume of sales whereas *“profitability”* would take account of revenue and costs. If it means something else then that only serves to underscore the potential for confusion. Sometimes the prospectus refers to one meaning or the other, for example Schedule 1, page 41, refers to *“Feltex’s carpet sales in dollar terms”*, whereas the growth assumption is linked to volume.

247 This also emphasises the importance of volume.

248 This table does not disclose that SIPS is included, a matter dealt with at section 29. It is likely retail investors reading that table would fail to understand that the revenue was not wholly sales revenue.

- 17.8 The prospectus emphasises the importance of revenue and sales (both volume and price) being maintained by way of the following assumption for the forecast FY04 (Schedule 1L, page 89) states:

REVENUE

The forecast assumes that demand for Feltex products continues the trend experienced over the nine months ended March 2004 (adjusted for increased fourth quarter seasonality), that a small volume of new product is introduced into the market and that existing customers will continue to trade with Feltex at their current levels.

- 17.9 That assumption is expressed in the context of the forecast for FY04. It makes plain the forecast is for the 4th quarter, namely the months of April, May and June 2004, which is coupled with actual performance for the preceding nine months to produce the forecast figure on page 85.
- 17.10 The importance of the 4th quarter is underscored by the reference to an adjustment for “*increased fourth quarter seasonality*”, which represents an increased 4th quarter sales.
- 17.11 In summary thus far, the prospectus represents that sales revenue (and volume) and growth in those are important. There is additional emphasis on the forecast sales revenue for the 4th quarter FY04. Those matters were clearly important to the defendants, who must have or ought to have known that potential investors would likely place weight on the representations. Revenue, or increasing revenue, as well as its components of sales volumes and price, would likely be regarded by potential investors as an integral part of the “success” and “growth” portrayed in the prospectus, and essential to dividend yield.
- 17.12 The repeated positive assertions as to revenue and growth serve to illustrate the earlier issue referred to regarding risk disclosure: that risk disclosure must weigh against those positive assertions.
- 17.13 Feltex was especially sensitive to sales revenue fluctuations because of its high breakeven cost structure. This is apparent from the statement by Mr Saunders to the 2005 AGM,²⁴⁹ with which Mr Magill agreed,²⁵⁰ in which Mr Saunders states:

249 CB20 014401 @ 014405
250 NOE (Magill) page 1903, lines 15-20

A reality is that the carpet industry has a fairly high breakeven cost structure. Once you go through this breakeven point the margin on incremental production is very high and flows directly to the bottom line. The reverse also applies.

17.14 Those high break even costs and sensitivity to revenue change were sufficiently important for Mr Magill to explain them at pre-IPO presentations:**251**

- A. *Well I can only relate Your Honour to some of the presentations I did before the IPO, um, I did mentioned that the carpet companies have huge capital investment, they have high cost structures, and I explained to those meetings that when you went through the breakeven point you made a lot of money very quickly. Obviously if you didn't get the sales, the revenue, then obviously, because of the high breakeven costs then it would go into losses so I did explain that to the brokers, I did explain at the meetings that I attended so far as I was concerned I had highlighted that to the investors prior to the IPO.*
- Q. *But I was asking you, not whether you'd disclosed it in your meetings or road shows with brokers and market participants but that there is nothing in the Prospectus to tell investors –*
- A. *There's nothing in the Prospectus that specifically states that, that is correct sir.*
- Q. *But you, nevertheless thought it was important to tell –*
- A. *Yes I did sir.*
- Q. *- people, the brokers?*
- A. *I did sir.*

17.15 Mr Cameron confirmed that retail investors may not understand the implications of a high break even cost structure and that Feltex had a high break even cost structure.**252**

17.16 Sensitivity to sales revenue was such that when there was an earnings and volume shortfall in May 2003 (after the bond issue) Mr Thomas emailed Mr Magill enquiring into this. The exchange (ultimately copied to all directors) involved Mr Thomas asking:**253**

*Sam,
While the EBITDA result is impressive, and heartening, it would have been more reassuring if the Revenue side had met forecast, rather than the cost side holding in line, allowing EBITDA to be achieved (nearly) through cost savings (vs forecast) in cost/expense items between Margin and EBITDA, rather than revenue attainment, and gross margin contribution???*

251 NOE (Magill) page 1905, line 27 – page 1906, line 11
 252 Cameron NOE 2379 line 30 to page 2380 line 11
 253 CB6 004389 @ 004391 [CB6 004392]

Why are we missing Sales Forecasts (dollars and volumes) by such margins. Are we losing market share in total market, or in any sector?? Given the "forecast" was prepared/confirmed in March, to miss May by such a margin (15.7% in dollars, and 18% in volume) is baffling??

*Regards,
Peter*

- 17.17 As can be seen, sales dollars (revenue) and volume were important to Mr Thomas, despite his evidence minimising the importance of volume. As will be seen later, another concern of Mr Thomas in that email, of Feltex's losing market share, was realised in 2004 – a matter that was known by the Due Diligence Committee and Board pre-IPO.
- 17.18 The explanations given by Mr. Magill in evidence in respect of the failure to meet sales targets and yet still meet EBITDA and NPAT for FY03, FY04 and 1H FY05 rely on reversal of costs or provisions and release of SIP grants.
- Q. Could I just take you to your brief of evidence please at 174 and in the first of the bullet points of the extract of the record of what you reported to the Board at its meeting on the 22nd and 23rd of February you said that, "January was a poor sales month but whilst the market is difficult there are signs of improvement." Do you recall now what those signs were?
- A. *It's a long time ago. Um, well I think that what I relied on, in my mind Your Honour, was that if you go to the year before, January and February were also poor selling months but March 2004 we actually had a record sales month and in the back of my mind I still felt that February and March would improve.*
- Q. But I just wanted to know do you recall why you were of that view?
- A. *Well the quarterly rebates were going to kick in in March, right. January can be a very slow month, which it was and it was the year before, but it still picked up in late February and March was a record sales month in 2004.*
- Q. And at page, sorry, paragraph 176 at the Board meeting which you attended by telephone from overseas on the 29th of March it's recorded that you reported, or you said you reported that March, "Sales have continued to struggle," but then you say in the next paragraph, "I did not personally believe that an updated forecast would be necessary and I remain confident the company would meet its projection figures for the full year."
- A. Yes.
- Q. Again, apart from – well, did that include because of the rebates kicking in? Well basically, very simplistically, in my mind, in February we had a workers rebate coming of \$1 million. We had, um, SIP, still

to get, of 3.7 million, so that was 4.7 million. We had internal margins of 6.5 million so that's 11 million. After tax, it's something like about 8 million would flow to the bottom line so that's why I was still confident to be able to meet the net profit after tax position in February.

A. *Even though the sales were declining and volume was declining I was still confident, in February, that we would meet the net profit after tax figures that was in the Prospectus for the year 2005.*

Q. And you continued to be of that view, didn't you, notwithstanding that the, it was agreed that there should be a profit downgrade issued on the 1st of April?

A. *No that's not correct Mr Forbes. What, when I came back and the sales people, who had been positive in February, had turned negative when the sales started to slow in early March, and that's what happens with sales people. If they have a couple of bad months then they'll start turning down all their forecasts and projections, right, so it's understandable that they would do that so I wasn't sure till I got back in Australia and went through all the numbers with Des and John Kovic to whether there needed to be a change in the projections or a signal to the market that things needed to change.*

17.19 Given the importance placed in the prospectus on sales revenue, especially for the last quarter FY04, a shortfall²⁵⁴ against forecast for any of the months of April, May and June 2004, could be reasonably foreseen to be important to a potential investor.²⁵⁵ It would mean that the:

- (a) performance for FY04 may not be met;
- (b) forecasting system of Feltex and underlying assumptions were flawed or inaccurate for one (April 2004), two (April and May 2004) or, if allotment was delayed past 2 June 2004, three months (April to June 2004);
- (c) validity of the projection for FY05 would be called into doubt, as it was based on the forecast FY04;
- (d) positive claims about Feltex in the prospectus, as to performance and growth, might not be well founded.

Sales revenue data was known or reasonably available

254 It would not matter if performance was better, for the Securities Act 1978 disclosure provisions are directed at adverse circumstances.

255 BP5 004400 @ CB004413, refer key points.

17.20 Unsurprisingly, given its importance, sales revenue information was readily available to the Board and Due Diligence Committee, and thus all defendants, in a number of ways. It was recorded in the monthly Group Operating Reports. Mr Magill²⁵⁶ and Mr Tolan²⁵⁷ received daily sales reports. Those reports were just that, daily, and included volume, revenue, margin and budget. Mr Magill sat on the Board. Mr Tolan sat on the Due Diligence Committee and attended Board meetings. Both were interviewed by the Due Diligence Committee.

What the sales revenue data shows

17.21 The sales revenue data paints a concerning picture. The commentary in the Group Financial results contained within the monthly Group Operating Reports from January to May 2004 include:

January 2004 258

*Total carpet volume was 27.2% below budget...
Carpet revenue was under budget by 29.0%...
Carpet margin dollars were below budget by 16.3% (\$879k)...
Carpet margin percent exceeded budget by 4.8% reflecting a more favourable mix and lower costs...*

February 2004 259

*Total carpet volume was 9.6% below budget due to lower than expected orders over January and February...
Carpet revenue was below budget by 19.2% (\$4,584k)...
Carpet margin dollars were below budget by 12.3% (\$874k)...
Carpet margin % exceeded budget by 2.6% reflecting a lower cost mix...*

March 2004 260

*Total carpet volume exceeded budget by 2.0% reflecting a rebound in orders after lower than expected orders over January and February...
Carpet revenue exceeded budget by 1.4% (\$338k)...*

256 NOE (Magill) page 1940, lines 18 - 29

257 NOE (Tolan) page 1564, lines 4-10. See also Meredith BOE [207]

258 From the Group Operating Report for January 2004 [BP4 003228] at page [003235], which was included in the Board Papers of 24 February 2004 [BP4 003218] and reviewed in the board minutes of 24 February 2004 [BP4 003512 at 3518]. See Magill NOE page 1926; Saunders NOE page 2175

259 From the Group Operating Report for February 2004 [BP4 003529] at page [003537], which was included in the Board Papers of 1 April 2004 [BP4 003512] and reviewed in the Board minutes of 1 April 2004 [CB10 007642 at 7643]. See Saunders NOE 2177

260 From the Group Operating Report for March 2004 [BP5 003677] at page [003685], which was included in the Board Papers of 27 April 2004 [BP5 003671] and reviewed in the Board minutes of 27 April 2004 [BP4 003345 at 3348]. See Saunders NOE 2180

Carpet margin dollars were 13.8% (\$969k) above budget driven by higher than budgeted sales in the middle segment and Australian Commercial, which was 56.6% above budget... Carpet margin % exceeded budget by 3.6% reflecting a lower cost mix...

April 2004 261

Total carpet volume was under budget by 19.5% reflecting a quieter than expected month by retailers and a fall in orders following a peak in March... Total carpet revenue was 22.8% below budget or \$6.1m... Overall residential was 27.1% below budget mainly due to lower volumes but also lower average selling prices... Carpet margin dollars were 6.1% (\$467k) below budget... Residential margin was \$392k (6.9%) below budget... Carpet margin % exceeded budget by 6.2% due to a lower cost mix, favourable operating variances and offset by higher than budgeted sales of seconds and aged stock...

May 2004 262

Total carpet volume was under budget by 17.8% reflecting a quieter than expected month in both the residential and commercial segments... Total carpet revenue was 23.2% below budget or \$6.9m. This was largely a result of lower volumes... Overall residential was 21.9% below budget mainly due to lower volumes and lower average selling prices... Carpet margin dollars were 11.2% (\$945k) below budget on significantly lower sales, reflecting a cost mix, offset by favourable operating variances (materials and stock obsolescence) in Australia and New Zealand. Carpet margin % exceeded budget by 4.4% driven by stronger selling prices in Australian commercial and a lower cost mix in residential.

17.21 June was surprisingly positive:**263**

Total carpet volume exceeded budget by 17.0% reflecting a better than expected month in both the residential and commercial segments... Overall commercial was 48.9% above budget, due to strong sales in Australia, which was 65.8% higher than budget. Total carpet revenue was 13.7% above budget or \$3.5m. This was due to higher than budgeted volumes. Average selling prices were below budget in all segments except Australia Commercial,

-
- 261 From the Group Operating Report for April 2004 [BP4 003353] at page [003362], which was included in the Board Package for April 2004 [BP4 003345] and reviewed, although no minutes record this. See Thomas NOE 1281 & 1476; Magill NOE 1935
- 262 From the Group Operating Report for May 2004 [BP5 003858] at page [003867], which was included in the Board Papers of 22 June 2004 [BP5 003820] and reviewed in the Board minutes of 22 June 2004 [BP5 004012 at 4023]. See Thomas NOE 1484; Magill NOE 1938; Saunders NOE 2182.
- 263 From the Group Operating Report for June 2004 [BP5 004030] at page [004038], which was included in the Board Papers of 27 July 2004 [BP5 004012] and reviewed in the Board minutes of 27 July 2004 [BP5 004152 at 4181]. See Thomas NOE 1485.

which was slightly higher than budget. This was partially due to higher than budgeted sales of discounted seconds, aged stock, and promotional discounts.

Overall Residential was 4.9% above budget. This does not correspond to the increase in volume due to lower average selling prices...

Carpet margin dollars were 20.0% (\$1,549k) above budget, reflecting a lower cost mix, and favourable operating variances in Australia and New Zealand...

17.22 The report for May 2004 was not available prior to the issue of the prospectus on 5 May 2004. However, key financial data on which the May 2004 Group Operating Reports was based was available by way of the daily sales reports. Moreover, the reports are compiled by Mr Tolan and Mr Magill.²⁶⁴ . It is unlikely that they could not readily ascertain sales data and reasons.

17.23 That the data for May was available prior to allotment was clear from the Due Diligence Committee meeting of 2 June 2004, in which Mr Magill and Mr Tolan are recorded as advising the committee of the April and May performance:**265**

3.1 Chief Executive Officer

Sam Magill gave the Committee an update on Company performance. He advised that the forecasts to 30 June 2004 were based on the market knowledge available at the time the forecasts were set. The Company is set to meet, and may in fact exceed, the \$41.6 million EBITDA forecast for the year ending 30 June 2004.

However, Sam Magill advised that the Company might not meet its sales forecast for this period due to the following reasons:...

However, the market slowed in April and May and retailers have taken longer than expected to move the stock they purchased in March. ...

The amount of shortfall in sales revenue compared to forecast would be in the order of NZ\$7.5 to \$9 million (less than 3% of annual sales)...

3.3 Chief Financial Officer 266

The only number in the forecast that may not be achieved is the sales number and there should not be an issue with any of the other forecast amounts. Des confirmed that the Company's balance sheet should be in line with the forecast balance sheet. Des indicated that the sales shortfall would be between \$7.5 million and \$9 million for

²⁶⁴ See NOE (Tolan) page 1666; NOE (Magill) page 1943, lines 18 - 29
²⁶⁵ DD2 000751 @ 000753
²⁶⁶ DD2 000751 @ 000754

the year ending June 2004, which translates to a shortfall of approximately 2.8% of annual sales. Sales for the fourth quarter were currently down around 10% but the feedback from the market indicates that June will be a strong month as the retailers push for their quarterly rebates...

- 17.24 The data and commentary in the Group Operating Reports show a revenue shortfall from budget, for January and February 2004, of 29% and 19.2% respectively. March exceeded budget, but only by 1.4%. The revenue shortfall from forecast April 2004 was 22.8%, which was quantified as \$6.1 million, and for May 2004 was 23.2%, or \$6.9 million.**267**
- 17.25 Those shortfalls exceed the shortfall in revenue in May 2003 of 15.7% that has been of sufficient concern to Mr Thomas in May 2003 to cause him to make direct inquiry of Mr Magill.**268**
- 17.26 It should have been obvious to defendants that those shortfalls were substantial and could not be made up in June 2004, unless that month unexpectedly outperformed to a very substantial extent. The FY04 year to date revenue shortfall against forecast as at April 2004 was \$5,557,000**269** and by May 2004 was \$11,884,000.**270** Equally obvious was that mere oral assurances that June was expected to be a good month were an insufficiently reliable basis for an IPO. The reason is apparent from the commentary in the Group Operating Reports. The February 2004 group operating report stated there had *“lower than expected orders over January and February”*; the April 2004 group operating report referred to *“a quieter than expected month by retailers and a fall in orders following a peak in March”*; and the May 2004 report *“a quieter than expected month...”*.
- 17.27 Those comments do not reflect a shortfall against an allegedly aggressive budget: they reflect a shortfall against expectations and evidence that expectations are unreliable. Although June 2004 was more positive than expected,**271** a depressed pattern of sales was evident, which could also be identified by checking volume data. It was apparent from the market volume presentation given to the Due Diligence Committee on 8 April 2004.**272** This

267 It appears the style of the group operating reports was not changed thus the word “budget” is still used.

268 CB6 004389 at 004391 [CB6 004392]

269 BP4 003345 @ 003379

270 BP5 003820 @ 003885 (shortfall for the month was \$6,302,000 see 3884)

221 BP5 004012 @ 004038

272 CB11 007831

showed a sixth year of decline in market share. Those are turned to in the next topic.

17.28 The Group Operating Reports also included financial data in the form of Group Trading Results showing that sales revenue for each month to May 2004 in the second half of FY04 was down against the second half of FY2003.

Sales (NZ\$ 000)	Total				Variance		
	Actual	Budget	Forecast	Last year	Budget	Forecast	Last year
January 2004 ²⁷³	16,912	22,983		17,785	(6,071)		(873)
February 2004 ²⁷⁴	22,425	27,576		24,343	(5,151)		(1,918)
March 2004 ²⁷⁵	28,210	27,421		25,337	789		2,873
April 2004 ²⁷⁶	24,271	30,565	29,828	27,500	(6,294)	(5,557)	(3,229)
May 2004 ²⁷⁷	26,657	33,982	32,959	27,256	(7,325)	(6,302)	(599)

17.29 As can be seen, FY04 sales revenue for:

- (a) January was 95.09% of the actual for the comparable month in the previous year;
- (b) February was 92.12% of the actual for the comparable month in the previous year;
- (c) March was 111.34% of the actual for the comparable month in the previous year;
- (d) April was 88.26% of the actual for the comparable month in the previous year;
- (e) May was 97.80% of the actual for the comparable month in the previous year.

17.30 It may be that in usual circumstances and measured over a long time frame a revenue shortfall in a solitary month is less concerning. However the

273 BP4 003218 @ 003248 - Figures taken from the January 2004 group operating report contained in the 24 February 2004 board papers. See Saunders NOE page 2179, line 3 - 21

274 BP4 003512 @ 003554 - Figures taken from the February 2004 group operating report contained in the 1 April 2004 board papers. See Saunders NOE page 2180, line 13 - 34

275 BP5 003671 @ 003702 - Figures taken from the March 2004 group operating report contained in the 27 April 2004 board papers. See Saunders NOE page 2182, line 14 - 16

276 BP4 003345 @ 003379 - Figures taken from the April 2004 group operating report contained in board package for April 2004. See Saunders NOE page 2183, line 22

277 BP5 003820 @ 003884 - Figures taken from the May 2004 group operating report contained in the 22 June 2004 board papers. See Saunders NOE page 2185, line 4 - 14

circumstances were not usual. First, the context was a forthcoming substantial IPO. Secondly, this was a pattern of underperformance, not a solitary month. Thirdly, a solitary month of significant underperformance is important where that month is one of only three subject to a forecast.

- 17.31 There was also a fourth factor meaning this data was very important: the sales revenue projection for FY05 of \$346,653,000 was based on the forecast for FY04 of \$331,224,000, with an-uplift of 4.7%.²⁷⁸ The sales revenue shortfall to May 2004 meant that a much greater uplift would be needed in order to meet the projection for FY05. Even on the basis put by Mr Magill and Mr Tolan at the Due Diligence bring down meeting of 2 June 2004, based on oral assertions that June 2004 would outperform, the sales revenue shortfall would be \$7.5 to 9 million. The increase from then anticipated sales revenue for FY04 of \$322,224,000 to \$323,724,000 to that projected for FY05 of \$346,653,000 was 7.08% to 7.58%.²⁷⁹
- 17.32 That meant that an increase from 4.7% to between 7.08% and 7.58% would be required, an additional increase of 2.38% to 2.88%. To put this in perspective, as at May 2004 year to date sales revenue was up 0.61% on the previous year.²⁸⁰ After the June 2004 results were to hand, the final percentage increase was up only 2.63% over FY2003.²⁸¹
- 17.33 In summary thus far the sales revenue data known by or available to the defendants should have put them on notice that there was a serious problem with sales revenue for FY04 and thus potentially a problem with the projection for FY05. Disclosure should have been made and allotment deferred until such time as proper inquiry was made.
- 17.34 The discussion recorded in the final Due Diligence Committee teleconference on 2 June 2004 (the bring down due diligence meeting)²⁸² cannot reasonably be called proper inquiry, let alone inquiry giving rise to a reasonable belief that the forecast and projection were able to be met. Amongst other things:

278 CB13 009725 at 'H~line Results Sensit NZD'. This was reviewed and approved by Board members. See Thomas BOE [108]

279 As it happened, the actual sales revenue for FY04 was \$323,539,000 which meant that an uplift of 7.14% would be required to meet the projection FY05.

280 BP5 003820 @ 003885

281 BP5 004012 @ 004056

282 DD2 000751 @ 000753 - 755

- (a) the underlying sales data was not called for and analysed, including against other data, eg volume, to see if there was a pattern or trend (which there was);
- (b) there was no assessment of the reasons and their implications for the projection for FY05, including the increased uplift now required for it to be met;
- (c) oral assertions by Mr Magill and Mr Tolan as to June being expected to outperform were an insufficient basis for assurance, especially given the previously missed budgets and forecasts against expectations;
- (d) no formal opinion or evaluation was not sought. To decide to allot in that teleconference without further inquiry was inadequate.

17.35 The decision not to notify the shortfall to the market was misplaced: the sales shortfall was a material adverse circumstance which meant that the prospectus was now misleading. The SA 1978 provides an easy mechanism for notification, being the amendment by way of memorandum pursuant to s43. Allotment should have been deferred.

17.36 Materiality should have been evident, however an error in approach to assessing that is apparent from the Due Diligence Committee minutes of 2 June 2004. First, there was inadequate information due to the lack of proper inquiry. Second, the materiality was not assessed with regard to its broader potential impact. Thirdly, the assessment was against the wrong time frame.

17.37 Given that the forecast was for the three months 4th quarter FY04, the significance or materiality²⁸³ should have been against those three months or such of them as had by then occurred, ie two months. This ought to have lead swiftly to the conclusion that the shortfall, in April 2004 of 22.8%, which was quantified as \$6.1 million, and in May 2004 of 23.2%, or \$6.9 million, was clearly material.

17.38 Instead, the shortfall was assessed against twelve months and included the prospective outperformance for June 2004 asserted by Mr Magill and Mr Tolan. This approach was not like for like and was speculative. It is

consistent with using an approach most likely to allow allotment to proceed, rather than an approach which best met the requirements of the SA 1978. Had inquiry been made then certain other information would or should have been brought into sharp focus, which information was also available pre-allotment. Reference is now made to this and again at paragraphs 25.9 to 25.27

Carpet Call / Solomon's

- 17.39 Since December 2003 there had been a trend of declining sales to one of Feltex's largest customers, if not the largest²⁸⁴, Carpet Call / Solomons, the principal being Mr Jim Smith.²⁸⁵ The decline was such that the May 2004 group operating report stated "*Carpet Call who had their worst month ever, was a major contributing factor. Jim Smith is not giving us any support whatsoever.*"²⁸⁶ This is referred to more fully later.

Increased competition

- 17.40 Feltex was also facing increased domestic competition from its main competitor, Godfrey Hirst. It was likely to be compounded by increased competition from imports as a result of tariff reductions. These are also referred to more fully later.

Disclosure of the shortfall

- 17.41 The issue of the revenue shortfall cannot be said to have been adequately disclosed to the market by way of an NZX announcement dated 24 August 2004²⁸⁷ and the publication of the FY04 annual report. The quantum was included but explanation of the implications for FY05 was lacking. For example the annual report included:²⁸⁸

Lower than forecast sales in April and May 2004, particularly in the lower price value segments of the business. The shortfall was to some extent made up by the stronger than forecast sales in the month of June 2004. Sales were below forecast in the fourth quarter;

284 DD1 000534 @ 000537. In his interview with the Due Diligence Committee Mr Lyons advised that Carpet Call had the highest annual revenue at A\$19m. This was attributed in part to Mr Lyons treating Carpet Court NSW (A\$18m) and Carpet Court Victoria (A\$13m) as separate customers.

285 CB17 012663 @ 012683

286 BP5 003820 @ 003871

287 CB17 012791

288 CB17 012265 @ 012269

however the Group achieved a superior product mix of sales, yielding higher than forecast margins ...

17.42 Illuminatingly, the commentary is (appropriately) confined to the forecast period, as opposed to the 12 month basis for comparison at the Due Diligence bring down meeting of 2 June 2004. Despite having missed the revenue projection for FY04, there was still no revision issued for the revenue projection FY05. Investors cannot be expected to have understood the full significance.

Conclusion

17.43 Feltex had a shortfall in sales revenue for the second half FY04 up to the allotment in June 2004, measured against budget, forecast and the corresponding period the previous year. A downward pattern was apparent. The shortfall against the forecast up to the date of allotment was substantial and comprised a material adverse circumstance.

17.44 The defendants knew that the forecast total operating revenue for FY04 could not be met by the time of the Due Diligence bring down meeting, if not before. The JLM's were both represented at this meeting. Mr Thomas was also present, on behalf of Credit Suisse. The forecast FY04 and projection FY05 based on that should have been revised. They were not. There was sufficient information to place the defendants on notice of the need to make or initiate proper inquiry. They did not, but continued with allotment on 2 June 2004. Proper inquiry would have made a difference.

17.45 The failure to disclose the revenue shortfall and consequent inability to meet the forecast FY04, when sales revenue had been so emphasised in the prospectus, and a downward pattern was evident, was misleading and deceptive, or likely to mislead or deceive. It was also the result of negligence. The inability to meet the forecast FY04 and projection FY05 will be returned to later.

18. Sales volume

Pleadings

18.1 Evidence of sales volume and trends therein are able to be pursued - evidence ought not to be pleaded. Sales volume bears on the pleadings

referred to under sales revenue. Sales volume is also included in other pleadings in the 4th ASOC:

- 46 Schedule 1 L, prospectus p 89, was misleading. The forecast assumed that the revenue demand would continue. Actual sales were falling and Feltex was failing to achieve its year to date forecasts;
- 46.5 Schedule 1 M, prospectus p90-91 was misleading. The projection assumptions include Feltex successfully implementing the strategies outlined and increasing its market share by 1% over the projected period. Many risk factors incorporated in para 46.5 are volume sensitive: domestic competition (56), tariff competition (57), the high break even structure that meant that *“small reductions in over all sales volumes would dramatically reduce the bottom line as acknowledged in the Saunders 2005 AGM statement”* (59) and the use of accelerated sales into June 2004 (63.2.3);

Sales volume was important

- 18.2 Sales volume is important for the same reason that sales revenue is. Its importance was portrayed in the prospectus by the many references to growth. Examples are set out under *“Sales revenue”* and include the letter from the Chairman Mr Saunders referring to *“driving future growth and earnings”*,²⁸⁹ the excellent investment features including a *“strong competitive position”*²⁹⁰ and under *“Investment Features”* on p16:

Feltex now has the infrastructure, manufacturing capacity, cost base and the following key strategies in place to capitalise on market opportunities and support further revenue and earnings growth:

- *the introduction of new product ranges and styles to recapture and grow market share.*²⁹¹

- 18.3 The same part of the prospectus refers to monitoring opportunities to *“augment organic growth”*²⁹² and a positive outlook for carpet demand.

- 18.4 More strikingly, Feltex’s business description, prospectus p41, commences:

Feltex is one of the two largest carpet manufacturers in Australasia, producing in excess of 17 million square meters of carpet in the year ended June 2003. Feltex estimates its production represented over a quarter of all the carpet volume manufactured in Australasia in 2003.

289 Prospectus, p 13
 290 Prospectus, p 16
 291 Prospectus, p 16
 292 Prospectus, p 16

18.5 The forecast for FY2004 and projection for FY2005 on p85 of the prospectus, both of which are challenged, are based on certain assumptions that import volume:

(a) for forecast FY2004 a “Revenue” assumption:**293**

The forecast assumes that demand for Feltex products continues the trend experienced over the nine months ended March 2004 (adjusted for increased fourth quarter seasonality), that a small volume of new product is introduced into the market and that existing customers will continue to trade with Feltex at their current levels.

(b) for projection FY2005 a “Revenue” assumption:**294**

The projection assumes that the market will grow as described above under the headings ‘Industry Conditions’...that Feltex will successfully implement the strategies under the heading ‘Business Description’, resulting in Feltex’s market share increasing by approximately 1% over the projected period. No change in selling prices for carpets is assumed during the projected period.

18.6 The “Industry conditions” referred to in the projection for FY2005 revenue assumption are contained on the same page and state that

“The size of the carpet market in New Zealand and Australia, measured by volume of lineal metres sold, will grow over the projected period by approximately 1% ...”.295.

As a consequence, the revenue assumption can only be interpreted as meaning growth by Feltex in the volume of carpet sold, a matter accepted (reluctantly in some cases) by defence witnesses²⁹⁶. This is apparent also from the letter of 3 June 2005 from Bell Gully, as solicitors for Feltex, to the Securities Commission, in which they advised that

*“Market share is derived from actual, forecast or projected sales volumes of Feltex for a given period”**297***

and set out the basis of the projected increase.

18.7 The importance of volume is underscored by the fact that the projection assumed

“No change in selling prices for carpets...”.

293 Prospectus, p 89

294 Prospectus, p 91

295 Prospectus, p 91

²⁹⁶ CB 1 000047 @ 000165 Saunders NOE 1811

297 CB1 000165 @ 000170

Clearly, increased revenue was intended to come about as a result of increased volume.

- 18.8 The importance of volume to the business of Feltex and the IPO is reflected by the above, but its importance is apparent in other ways:
- (a) volume was the first item in the Group Trading Report table contained in the Group Operating Reports²⁹⁸, as well as the first item in the Commentary;²⁹⁹
 - (b) it was referred to at Board meetings;
 - (c) the forecasting process utilised volume data. The income and costings were based on actual volumes sold and price.³⁰⁰
 - (d) the projection FY05 was based on an increase in volume from the forecast FY04, which itself was based on volume;
 - (e) the due diligence process involved consideration of volume, revenue and market share by volume.
- 18.9 In Mr Tolan's Due Diligence interview he identified volume as the key driver of revenue:³⁰¹

Sensitivity of revenue - key revenue drivers are:

1. *Volume is the biggest driver - generally will achieve budget if have sufficient volume.*

- 18.10 In summary, sales volume and growth therein were important to Feltex and were so represented to potential investors.

Sales volume data was known or reasonably available

- 18.11 Sales volume was known or available to the Board and the Due Diligence Committee in the same way as sales revenue was: from the monthly Group Operating Reports, daily sales reports and the knowledge of Mr Magill and Mr Tolan to which they had access.

298 By way of example, the 24 February 2004 board papers [BP4 003218] contained the January 2004 Group Operating Report [@ 003228] which included the Group Management Trading Result [003248]

299 BP4 003218 003235

300 Tolan, BOE [19]-[20] See also CB 007925 xls/...

301 DD1 000221 @ 000222

What the sales volume data shows

18.12 In FY2004 up to May 2004 sales volume was generally significantly less than budget, the forecast from April 2004 and the previous year, when measured over a number of relevant timeframes. This is shown in Exhibit 5 *Volume of sales taken from Group Operating Reports from April 2003 to June 2005*.

302

Volume of sales taken from Group Operating Reports from April 2003 to June 2005 (1)

FINANCIAL YEAR 2003 (FOURTH QUARTER)													ECB reference				
Carpet Volume (000's m2)	Total				Variance between actual and budget				Variance between actual and forecast					Variance between actual and last year			
	Actual	Budget	Forecast	Last year	Budget	As a %	Average var. % from April 2003 to month		Forecast	As a %	Average var. % from April 2003 to month			Last year	As a %	Average var. % from April 2003 to month	
April 2003	1,445	1,562	1,449	1,270	-117	92.51%			-4	99.72%			175	113.78%			BP3 001932 at 1956
May 2003	1,449	1,746	1,618	1,595	-297	82.99%			-169	89.56%			-546	90.85%			BP3 002048 at 2075
June 2003	1,562	1,504	1,394	1,290	-142	90.56%	88.45%		82	97.70%	95.40%		72	105.54%	102.43%		BP3 002274 at 2301
Total	4,256	4,812	4,461	4,155													

FINANCIAL YEAR 2004													ECB reference				
Carpet Volume (000's m2)	Total				Variance between actual and budget				Variance between actual and forecast					Variance between actual and last year			
	Actual	Budget	Forecast	Last year	Budget	As a %	Average var. % from July 2003 to month	Average var. % from January 2004 to month	Forecast	As a %	Average var. % from April 2004 to month	Average var. % from January 2004 to month		Last year	As a %	Average var. % from July 2003 to month	Average var. % from January 2004 to month
July 2003	1,433	1,421		1,451	12	100.84%							-18	98.76%			BP3 002444 at 2483
August 2003	1,371	1,461		1,518	-90	93.84%							-145	90.44%			BP3 002568 at 2502
September 2003	1,438	1,559		1,512	-121	92.24%							-34	98.11%			BP4 002731 at 2764
October 2003	1,757	1,733		1,635	24	101.38%							122	107.46%			BP4 002937 at 2985
November 2003	1,603	1,662		1,616	-59	96.45%							-13	99.20%			BP4 003052 at 2879
December 2003	1,309	1,382		1,309	-73	94.72%							-	100.00%			BP4 003102 at 3132
January 2004	851	1,169		974	-318	72.80%	72.80%						-123	87.37%	87.37%		BP4 003218 at 3246
February 2004	1,257	1,390		1,406	-133	90.43%	82.38%						-149	89.60%	88.57%		BP4 003512 at 3552
March 2004	1,406	1,379		1,384	27	101.96%	94.44%	89.23%					22	101.59%	97.05%	95.36%	BP4 003671 at 3700
April 2004	1,240	1,540		1,538	-300	80.52%	92.38%	86.78%	-298	80.62%	80.62%		-325	85.81%	95.91%	91.27%	BP4 003845 at 3977
May 2004	1,413	1,719		1,706	-306	82.20%	91.86%	85.69%	-293	82.83%	81.78%		-36	97.52%	96.04%	92.63%	BP5 003820 at 3882
June 2004	1,741	1,488		1,362	253	117.00%	93.95%	91.05%	255	117.16%	92.90%		379	127.83%	98.59%	96.60%	BP5 004012 at 4057
Total	16,819	17,903	4,730	17,059													

FINANCIAL YEAR 2005													ECB reference				
Carpet Volume (000's m2)	Total				Variance between actual and budget				Variance between actual and forecast					Variance between actual and last year			
	Actual	Budget	Forecast	Last year	Budget	As a %	Average var. % from June 2004 to month		Forecast	As a %	Average var. % from June 2005 to month			Last year	As a %	Average var. % from June 2005 to month	
July 2004	1,224	1,339		1,433	-115	91.41%							-209	85.42%	85.42%		BP5 004152 at 4221
August 2004	1,200	1,447		1,371	-247	82.93%							-171	87.53%	86.45%		BP5 004400 at 4451
September 2004	1,650	1,729		1,438	-79	95.43%							212	114.74%	96.04%		BP6 004567 at 4627
October 2004	1,333	1,687		1,757	-354	79.02%							-434	75.87%	90.13%		BP6 004721 at 4795
November 2004	1,479	1,661		1,603	-182	89.04%							-124	92.26%	90.52%		BP6 004968 at 5007
December 2004	1,401	1,509		1,309	-102	93.21%							92	107.03%	93.00%		BP6 005040 at 5090
January 2005	804	1,194		851	-390	50.59%							-247	70.98%	91.08%		BP6 005192 at 5226
February 2005	1,204	1,455		1,257	-151	91.00%							67	105.33%	92.73%		BP7 005316 at 5362
March 2005	1,361	1,613		1,406	-252	84.38%							-45	96.80%	93.17%		BP7 005720 at 5826
April 2005	1,095	1,369		1,240	-274	79.99%			86	106.75%			-145	88.31%	92.73%		BP7 005937 at 6020
May 2005	1,527	1,549		1,413	-22	98.58%							114	108.07%	94.16%		BP7 006116 at 6185
June 2005	1,424	1,610		1,741	-186	85.45%	86.04%						-317	81.79%	92.86%		BP7 006296 at 6383
Total	15,622	18,156		16,819													

(1) The data in light blue is taken directly from the Group Operating Reports. The percentages have been calculated from that data.
 (2) The prospectus was based on 5 May 2004.
 (3) The final due diligence "Bring Down" meeting was held on 2 June 2004 therefore before June 2004 results were available.
 (4) The Group Operating Report for September 2003 states the "Actual" to be 1,340, whereas the Group Operating Report for September 2004 states the "Last Year" to be 1,438. The "Actual and forecast operating statement" dated 13 April 2004 (CB13 009725) uses 1,438 which results in a less unfavourable comparison than if 1,340 is used. Consequential amendments have been made to the variance between actual compared to budget and last year for financial year 2004.

18.13 As can be seen:

- (a) for the first nine months of FY04 to March 2004, being the period for which actual financial information was used in the prospectus, actual sales volume was 94.44% of budget and 97.05% of actual for the previous year;
- (b) that then deteriorated. For the first ten months of FY2004 to April 2004 actual sales volume was only 92.98% of budget and 95.91% of the previous year. For the eleven months to May 2004 actual sales

302 The data in this table is sourced and calculated in the way explained in it. The calculations could be done as a matter of submission, but the table means that is not necessary.

volume was only 91.86 percent of budget and 96.06% of the previous year;

- (c) for the period from January 2004 (ie during 2H FY2004) to:
 - (i) March, actual sales volume was 89.23% of budget and 93.36% of actual for the previous year;
 - (ii) April, actual sales volume was 86.78% of budget and 91.27% of actual for the previous year;
 - (iii) May, actual sales volume was 85.69% of budget and 92.63% of actual for the previous year;

- (d) for the forecast for FY04:
 - (i) sales volume for April was only 80.62% of that forecast;
 - (ii) sales volume for May was only 81.78% of that forecast.
 - (iii) the sales volume for April and May was only 81.78% of that forecast.

18.14 As with sales revenue, they are not isolated but show a pattern. The actual sales in FY2004 exceeded those in FY2003 only twice up until and including May 2004. These shortfalls occur during and are relevant to the context of the IPO. When, as here, a forecast, in this case for FY2004, is based on three forecast months April to June 2004, plus the nine prior actuals, whether sales volume was to be achieved in those three months was material – in this case a material adverse circumstances.

18.15 That significance is even greater given that the projection FY2005 was based on the forecast FY2004, with an uplift in projected volume of 5.1%, as seen in the *Summary of Financial Performance for the period ending June 2004 and June 2005* below:**303**



FELTEX CARPETS LIMITED
SUMMARY OF FINANCIAL PERFORMANCE
FOR THE PERIOD ENDING JUNE 2004 AND JUNE 2005

NZD 000

Sensitivity:	% Change
Volume	0.00 %
Average Selling Price	0.00 %
Margin	0.00 %

	FORECAST 2004	PROJECTION 2005	% Change
Sales - Volume - 000 m ²	17,152 m ²	18,020 m ²	5.1%
Sales - Net	<u>331,224</u>	<u>346,653</u>	<u>4.7%</u>
Net margin	103,062	112,994	9.6%
Net Margin %	31.1%	32.6%	1.5%
EBITDA	<u>45,482</u>	<u>52,683</u>	<u>15.8%</u>
M.I.P.	2,273	2,280	
Non-Operating Costs / (Income)	1,568	(1,280)	
EBITDA - Statutory	<u>41,641</u>	<u>51,683</u>	<u>24.1%</u>
Depreciation	8,076	8,427	
Goodwill	1,958	1,984	
ANZ Fee Amortisation	341	-	
Bond Costs Amortisation	4,881	-	
Bond Call Premium	5,014	-	
FX Contract Settlement	-	-	
EBIT	<u>21,371</u>	<u>41,272</u>	<u>93.1%</u>
Interest Paid	13,307	7,526	
Net Income Before Tax	<u>8,064</u>	<u>33,746</u>	<u>318.5%</u>
Taxation	(649)	11,335	
Net Income After Taxation	<u>8,713</u>	<u>22,411</u>	<u>157.2%</u>
Equity Earnings - Carpet Call	1,400	1,478	
Net Income	<u>10,113</u>	<u>23,889</u>	<u>136.2%</u>
Dividends	-	16,806	
Net surplus / (deficit)	<u>10,113</u>	<u>7,083</u>	<u>(30.0%)</u>

18.16 The declining volume apparent in FY2004 provides an extraordinary contrast to the projected increase of 5.1% for FY05.

18.17 A word is necessary about suggestions in evidence that the budgets were set as a "stretch", presumably meaning aspirational, budgets. In Mr Magill's interview with the Due Diligence Committee he stated:304

Some have said that the 2005 budget is too aggressive – the company budgeted in the 2003/2004 financial year 17.9 square million metres of sales. The budget for this year was just over 18 square million metres of sales. Sam said that the reason why Feltex didn't achieve the sales and volume budgets for the first 6 months of the 2003/2004 year, [sic] is because the company was working on new product and technology areas of the business, but it didn't get them moving quickly enough, these areas are now completed. In addition there was not enough solid colour yarn production of polypropylene out of the Hallam plant, this has been corrected and Hallam is moving to 100% of its capacity.

18.18 It is not suggested there that the FY2004 budget was set aggressively. Comments in that interview that some staff considered that previous budgets were too aggressive do not equate to the Board deliberately setting too aggressive a budget. In Mr Tolan's interview with the Due Diligence Committee he said that

“an aggressive budget was set for sales staff and the focus has been on margins, not volume”. **305**

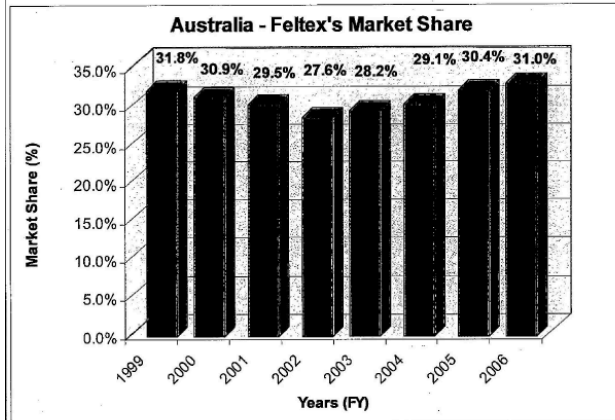
That aggressive setting is not reflected in contemporary documentation.

18.19 To the contrary, the budget for FY2004 was sent by Feltex, in a letter dated 30 October 2003 signed by Mr Tolan, to the ANZ bank with whom Feltex had borrowings of over \$90 million. **306** There is no suggestion in that letter that the budget was known to be aggressive and thus implicitly unrealistic. It was clearly considered by Feltex to be sufficiently realistic to send to ANZ who would presumably rely on it.

18.20 In short, if the budget for FY2004 was aggressive then the ANZ bank was being led astray, an unlikely proposition. More likely is that the budget turned out to have been too challenging.

18.21 Growth in market share was important to Feltex FY2004, a matter apparent from several sources. First, that same letter to the ANZ enclosed Feltex's three year plan, which included a comparison of Feltex's Australian market share (its main source of revenue) to total market size. It showed that although Feltex's market share had dropped year on year from 31.8% in 1999 to 27.6% in 2003, it was to increase to 28.2% in FY04. See the bar chart *Australian Market Share In Comparison to Total Market Size*. **307**

Australian Market Share In Comparison To Total Market Size



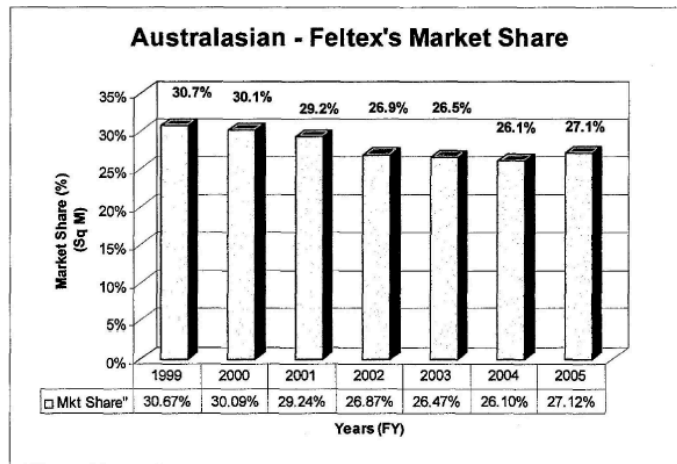
CB005256

Source: BIS Shrapnel, LEK & Feltex

18.22 Second, the budget for FY2004, presented to the Board on 24 June 2003, included a bar chart of past and planned market share, similar to that provided to the ANZ Bank, but for Australasia rather than just Australia. It also projected an increase in market share in FY04. **308**

18.23 The planned increase in market share did not eventuate. On 1 April 2004 **309** and 8 April 2004 the Board and Due Diligence Committee were presented with the forecast FY04 and projection FY05. It included the following bar chart *Australasian – Feltex Market Share*, **310** from which it can be seen that FY2004 was Feltex’s sixth consecutive year of decline in market share.

308 BP4 002048 @ 002250
 309 CB10 007642 Minutes 1 April 2004; CB10 007620 1 April 2004 presentation
 310 CB11 007831 @ 007845



CB007845

18.24 Third, the objective of growing market share is also apparent from the Board minutes of 30 September 2003, para 4.2.2, which record that:³¹¹

Mr Magill discussed the following:...

- *The objective is to hold onto the core margin business and grow Feltex's market share by accepting lower margin business that is currently being supplied by competitors....*

18.25 The reference to accepting lower margin business does not sit well with oral evidence that the focus was on higher margin business. That aside, in April 2004 the Board and Due Diligence Committee should have held especial concern about the ability of Feltex to grow market share, given its sixth consecutive loss in that regard.

18.26 Notwithstanding the six year decline, in the prospectus Feltex projected an increase in market share of 1% for FY05 and included an assumption to that effect. Feltex would have to first, halt the falling growth pattern of six years (including that for 2004 as forecast FY04) and second, increase growth, something it had clearly not achieved in the previous six years.

18.27 The bar chart above, *Australasian – Feltex's Market Share*, ³¹² was reproduced in Meredith's expert report. ³¹³ Of the reasonableness of the assumption he states

311 BP4 002736

312 CB11 007831 @ 007845

313 Meredith BOE dated 29 November 2013, pp61-62 esp para [241].

“...in my view, considering that the market share of Feltex has decreased every year since FY 1999, the assumption that it would then increase in FY05 does not appear to be reasonable.” 314

- 18.28 A word about strategy is appropriate. The six year decline presented in April 2004, in light of an objective to grow market share, should have caused the Board and Due Diligence committee to question Feltex’s strategy. There is no evidence of their doing so.
- 18.29 As can be seen from Exhibit 5 reproduced earlier, the decline in sales volume in FY2004 continued in FY2005, albeit increased somewhat. From that, and Feltex’s performance in FY2004 and FY2005, it can be reasonably inferred that Feltex did not have an adequate strategy, nor the supporting plan, people and systems, to achieve the represented and assumed growth in market share in FY2005.
- 18.30 While the prospectus made representations of growth, it did not set out a real strategy. Instead it contained persuasive and laudably worded goals. **315** Potential investors were thus bound to take the representations in the prospectus as to the strategy and its suitability at face value. Absent was key information required for analysis, such as the history of falling sales volume and falling market share.

Conclusion

- 18.31 Feltex’s sales volume in FY2004 was down against budget, forecast and actual, by a number of measures. The shortfall against forecast volume for April and May 2004 was very substantial. Feltex market share was also declining, year on year, including in FY2004, despite it then having a growth strategy. These were material adverse circumstances that were known to the defendants, yet were not disclosed in the prospectus nor pre-allotment. The representations and assumption paint quite a different picture.
- 18.32 They were sufficient to put the defendants on notice of the need to inquire and to revisit the forecast FY04 and the projection FY05 based on that. Those were not done. The failure to disclose the material adverse circumstances, given the revenue assumption of growth in market share and

314 Meredith BOE dated 29 November 2013, pp61 para [243].

315 See for example Prospectus, p 51.

statements as to strategy and supporting resources, and the making of the representations and assumptions as to growth were misleading and deceptive or likely to mislead or deceive.

18.33 That also resulted from negligence. The relevant information was available, or ought to have been available to all defendants. The importance of growth and volume meant that those matters should have been inquired into and addressed.

19. Forecast FY04

19.1 Problems with the forecast FY04 and assumptions are pleaded in 4th ASOC:

- 36 The information on pages 7, 15, 16, 19, 82, 83 (Schedule 1 B) and 13 (Schedule 1 CC, prospectus p13) gave inappropriate emphasis to EBITDA, which wrongly implied EBITDA was a reliable measure of the financial performance of Feltex. It concealed Feltex's falling sales trajectory and the directors knew by May 2004 that Feltex would not meet its sales forecast for FY04;
- 42.2.2.3 Feltex's relationship with Carpet Call were impaired as a result of cancellation of Feltex's guarantee of its overdraft facility in late November / early December 2003.
- 46 Schedule 1 L, prospectus pg 89, was misleading. The forecast assumed that the revenue demand would continue. Actual sales were falling and Feltex was failing to achieve its year to date forecasts;
- 46.1-5 Schedule 1 M, prospectus p90. The general assumptions underlying the forecast FY04 (and projection FY05) were misleading. They include no change to the competitive markets, no change to the import of carpets, relationships with retailers would remain unchanged and strategies would be successfully implemented to increase market share by approximately 1%;
- 64.1-3 The forecast FY04 at prospectus pp19 and 85 was misleading because the directors, Credit Suisse PE and Credit Suisse MP knew at the time of allotment that there would be a shortfall against sales revenue of \$7.5-9 million;
- 64.4-5 The forecast would have been overstated by \$17.5-19 million but for the revenue recognition pleaded in para 63.2.1 and \$25.5-\$29 million but for the accelerated sales pleaded in para 63.2.2.

19.2 The forecast for FY04 was a fundamental feature upon which Feltex shares were sold. It gave the company value and was the basis upon which a dividend could be paid. It was the basis for the projection for FY05, but with an uplift in sales revenue and volume.

- 19.3 The forecast FY04 was contained in the prospectus, page 85 and forecast revenue of \$335,498,000 and net surplus attributable to shareholders of \$10,113,000.³¹⁶ A forecast, in skeletal form, was included on page 19 of the prospectus, starting with the revenue of \$335,498,000. Strangely, the net surplus attributable to shareholders was missing. Instead there was a normalised NPAT (before amortisation, write-offs and early redemption amount) of \$22,307,000. That same page included a forecast adjusted for one off items, with a normalised NPAT of \$26,457,000. That page did not include reference to SIP grants being included in revenue.
- 19.4 A key element of the forecast FY04 was the total operating revenue. It was the top item on pages 19 and 85. Page 19 included the revenue for the years FY02 to FY05, allowing potential investors to observe the change in revenue, past and prospective. Page 85 placed the revenue forecast for FY04 alongside the revenue forecast for FY05. The revenue and changes in revenue over the years were thus portrayed to be important.
- 19.5 That importance was amplified by references to revenue and growth elsewhere, as have been outlined in the Sales Revenue and Volume topics in these submissions. An example, *“Investment Features”*, is the representation that Feltex has the infrastructure, plant, cost base and strategies to *“support further revenue and earnings growth”* ³¹⁷
- 19.6 Despite that, a shortfall occurred. The operating revenue for FY04 was \$327,755,000, being \$7,743,000 less than forecast only three months out from the end of the financial year, and one month out measured from the date of allotment.³¹⁸
- 19.7 Page 88 of the prospectus, under the heading *“Principal Assumptions Underlying The Forecasts”*, set out the principal assumptions upon which the forecast was based. The forecast was stated to have been prepared as at 4 May 2004 and that:³¹⁹

... Actual results for the nine month period ended March 2004 have been incorporated into the forecast. There is no present intention to

316 Prospectus p 85

317 Prospectus p 16

318 CB17 012265 @ 012318 – Feltex’s Annual Report to 30 June 2004. See Lim NOE 972 line 13-23; See Russell NOE 1099 line 8

319 Prospectus p 88

update the prospective financial information or to publish prospective financial information in the future.

19.8 As an aside, the caveat against there not being a present intention to update prospective financial information cannot mean that there would not be an update if adverse information came to light prior to allotment, for that would be in breach of the SA s34, which prohibits the distribution of a prospectus that is or becomes false or misleading, whether or not that was so before or after its date. The SA provides a simple mechanism to avoid that situation, being an amendment of the registered prospectus by way of memorandum under s43.

19.9 The assumptions included a revenue assumption:**320**

The forecast assumes that demand for Feltex products continues the trend experienced over the nine months ended March 2004 (adjusted for increased fourth quarter seasonality), that a small volume of new product is introduced into the market and that existing customers will continue to trade with Feltex at their current levels.

19.10 Potential investors were thus informed first, that the forecast financial information incorporated Feltex's actual results for the period 1 July 2003 to 31 March 2004, meaning that any difference between the actual result and the forecast could result only from the performance of Feltex in the forecast period 1 April 2004 to 30 June 2004; secondly that the revenue side of the forecast was important, otherwise it would not have been the subject of an assumption; and thirdly that the revenue and demand were assumed to continue. Investors already knew, as a result of the revenue representations in the prospectus referred to earlier, that Feltex was intending to increase its revenue.

19.11 That is part of the context in which the importance of the forecast, in particular forecast revenue, and the significance of any shortfall in revenue, must be assessed. An assessment focussed mainly on whether EBITDA or NPAT was achieved fails to recognise the significance attached in the prospectus to revenue or the significance of revenue in the FY04 forecast to the projection for FY05.

Preparation of forecasts

19.12 Mr Tolan gave evidence of the process of forecasting sales.³²¹ The process is unclear. Software called “Demand Solutions” was used for budgeting and forecast purposes. Mr Lindsay Tadd, not Mr Tolan, operated that system.³²² It generated the sales forecast that was used as a basis for preparing the forecast and projection.³²³

19.13 There has been suggestion by defence witnesses that the budget had an element of “stretch”, a matter dealt with under Volume. If so then that would have implications for the forecast FY04, given the projection FY05 was based on that. Mr Tolan confirmed that:³²⁴

The process for preparing the 2004 forecast for inclusion in the prospectus was similar to that which we followed when preparing budgets, except that by the time we came to prepare it we had actual figures for the first nine months of the financial year...

19.14 That the process was similar and thus that there were implications for the achievability of the forecast for FY04 and projection for FY05 is readily apparent when the data in the Group Operating Reports is considered.³²⁵

Table 3: Excerpts from Group Operating Report (April 2004 to June 2004)

	Volume (000 m2)				Sales Revenue (NZ\$ 000)			
	Actual	Budget	Forecast	L/year	Actual	Budget	Forecast	L/year
April 2004	1,240	1,540	1,538	1,445	24,271	30,565	29,828	27,500
May 2004	1,413	1,719	1,706	1,449	26,657	33,982	32,959	27,256
June 2004	1,741	1,488	1,486	1,362	33,030	29,643	28,831	26,504

19.15 It can be seen from the table above that the budgeted volumes are within 13,000m² of the forecast volumes. Forecast sales revenue is within approximately \$1,000,000 of the FY04 budget figures for each month in the period April to June 2004. Mr Tolan agreed that the forecast figures for FY04 were “similar” to those budgeted. **326**

321 Tolan, BOE [19]-[21]
 322 See (Tolan) NOE page 1569, line 16 to page 1570 line 11
 323 See (Tolan) NOE page 1569, line 19 - 31
 324 Tolan BOE [22] and NOE page 1568, line 28-30
 325 CB7 005241 @ 005242
 326 See (Tolan) NOE page 1658, lines 23-25

Performance in April 2004 to June 2004

- 19.16 In April 2004 and May 2004, Feltex (missed)/exceeded the forecast figures for each month by the following amounts:

	April 2004³²⁷	May 2004³²⁸
Volume (m2)	(298,000)	(293,000)
Sales Revenue	(\$5,557,000)	(\$6,302,000)
Margin	(\$1,325,000)	(\$1,909,000)
EBITDA (pre M.I.P)	(\$1,006,000)	(\$1,642,000)
EBITDA (after M.I.P)³²⁹	(\$931,000)	\$277,000
EBIT	(\$770,000)	\$380,000

- 19.17 Much of this information was readily available to the defendants. As addressed under Sales Revenue and Volume in these submissions, Mr Tolan and Mr Magill³³⁰ received daily sales reports which included volume, revenue and margin. By the time the prospectus was issued on 5 May 2004 the problems with April 2004 would have been apparent. By 2 June 2004 the problems with May 2004 would also have been apparent – a matter confirmed by the discussion at the 2 June 2004 Due Diligence bring down meeting. The decline in sales revenue, volume and market share covered earlier were known. This information should have alerted the defendants that the budgeting and forecasting system was ineffective at predicting sales revenue.

³²⁷ BP4 003345 at 3379 - Figures taken from the April 2004 Group Operating Report contained in the Board Package for April 2004

³²⁸ BP5 003820 at 3884 - Figures taken from the May 2004 Group Operating Report contained in the Board Papers for meeting 22 June 2004.

³²⁹ In May 2004 the Management Incentive Program accrual was reversed resulting in a \$1.642m deficit (vs forecast) becoming a \$277,000 surplus (vs. forecast). This contributed to Feltex achieving the forecast net surplus. See (Tolan) NOE page 1670 line 14 to page 1672 line16].

³³⁰ See (Magill) NOE page 1942, lines 18 - 29

19.18 This information was sufficient to place the defendants on notice of the need to make proper inquiry as to the FY2004 forecast performance. However, there was also data sufficient to place them on notice that the assumptions relating to the forecast were not reasonable.

The revenue assumptions

19.19 The revenue assumption³³¹ contains three elements:

- (a) *“demand for Feltex products continues the trend experienced over the nine months ended March 2004 (adjusted for increased fourth quarter seasonality)”*;
- (b) *“a small volume of new product is introduced into the market”* and
- (c) *“existing customers will continue to trade with Feltex at their current levels.”*

19.20 This was reviewed by Professor Robb.³³² The forecast sales revenue for the fourth quarter FY04 was \$91,618,000, an uplift of \$10,358,000 or 12.75%, compared to the fourth quarter FY2003.³³³ This comparison of corresponding quarters inherently takes account of any fourth quarter seasonality.

19.21 Professor Newberry’s assessment of the need for a substantial increase in sales in the 4th quarter FY04 was similar:³³⁴

The forecast sales for the final three months of the financial year called for sales to increase by 14.7% over the average monthly sales reported in the first nine months of the year.

19.22 In contrast, Feltex achieved an uplift of \$5,584,000 in sales revenue for the nine month period to 31 March in FY04 as against the comparable period for FY03, being an increase of 2.39%.³³⁵ Professor Robb concluded:

I have great difficulty reconciling Feltex’s nine month sales trend to March 2004 of a 2.39% growth in sales against the forecast growth of

331 Prospectus p 89

332 Professor Robb BOE [35]

333 Robb BOE [35.3] - [35.4]

334 Professor Newberry, BOE [72] states it is difficult to identify a trend for the period 1 July 2003 to 31 March 2004. Reported sales over that period averaged \$26,622,888 and that the forecast sales were to average \$30,539,333 despite the fact Feltex had only achieved sales in excess of \$30,000,000 on two out of the nine months.

335 Robb BOE [35.5]

12.75% in the period April to June 2004, in light of the prospectus assumption noted above. I do not consider that Feltex's forecast revenue figure of \$335,598,000 was reasonable if calculated using the assumptions stipulated in the 2004 prospectus.

19.23 The table below shows the extent of the shortfall measured by volume and revenue.

Table 4: Excerpts from Group Operating Report (April 2004 to May 2004)

	Volume (000 m2)				Sales Revenue (NZ\$ 000)			
	Actual	Budget	Forecast	L/year	Actual	Budget	Forecast	L/year
April 2004	1,240	1,540	1,538	1,445	24,271	30,565	29,828	27,500
May 2004	1,413	1,719	1,706	1,449	26,657	33,982	32,959	27,256

19.24 Professor Newberry³³⁶ states that while a shortfall against an aggressive budget is not a concern in itself, it should be if the sales revenues forecast in the prospectus for the remainder of 2004 is aggressive, rather than based on the reasonable and supportable assumptions as are required by FRS-29 for forecasts.³³⁷

19.25 By the end of April and May 2004 it must have been apparent that the forecast was not based on a reasonable and supportable assumption. That view is strengthened if regard is had, as it must be, to the monthly sales revenue and sales volume data for 2HFY04 as shown in the Sales Revenue and Volume sections of these submissions. Both were significantly down in January, February, April and May 2004 against the previous year and only up by a small percentage in March 2004.

19.26 The potential problem was apparent from the due diligence interview of 2 April 2004 with Mr Tolan. His comments included that:³³⁸

Volume is the biggest driver [of revenue]- generally will achieve budget if have sufficient volume...

and

However, recent volumes have been static or slightly down and growth in revenue has been from changes in product mix as Feltex seeks to move customers up the value chain.

and

336 Newberry BOE [71]-[72]
 337 Newberry BOE 29 November 2013, [72]
 338 DD1 000221 @ 000222

A slow January/February contributed to this shortfall in revenue. However, March was a very good month.

19.27 These comments should have alerted the defendants of the need to observe closely performance in April and May 2004, and make proper inquiry in the event of any shortfall. There were two other matters that ought to have caused concern.

Competition

19.28 The Board papers leading up to the date of allotment show cause for concern regarding increasing competition.

<i>Board Paper</i>	<i>ECB Ref</i>	<i>Comment</i>
<i>24 February 2004</i>	<i>BP4 003218 @ 3342</i>	<i>3.2 Commercial: "A tough month in Australia in January due to early invoicing of some projects in December and our ongoing battle to remain competitive with Australian made tufted products against Godfrey Hirst and Cavalier. Both these competitors pricing on medium to large projects are at or under our FAC's for equivalent products"</i>
<i>24 February 2004</i>	<i>BP4 003218 @ 3239</i>	<i>Opposition Activity: "Godfrey Hirst seem to have lost the plot and returned to the bad old days attacking the builder business and also focusing on several major accounts. We are trying to hold our business and are succeeding in some cases."</i>
<i>1 April 2004</i>	<i>BP4 003512 @ 3540</i>	<i>"The Godfrey Hirst sale has affected sales of the Invicta brand, with people not wanting to purchase stock as they were advised that there would be plenty of wool specials available."</i>
<i>1 April 2004</i>	<i>BP4 003512 @ 3541</i>	<i>"Of the majors, the talking point was the Godfrey Hirst warehouse sale. We were told the prices were very good, there were plenty of one and two rolls on offer but the sale was poorly organised and it soon leaked out that Carpet Choice had a preview. They also used this sale as an opportunity to take forward orders on several of their volume lines. We have heard varying reports from 140,000 to 200,000 linear metres was sold."</i>
<i>1 April 2004</i>	<i>BP4 003512 @ 3546</i>	<i>3.2 Commercial New Zealand: "A lack of secured customer work and a high level of promotional activity by Godfrey Hirst and Cavalier have impact on the New Zealand sales."</i>
<i>April 2004 Group Operating Report</i>	<i>BP4 003345 @ 3367</i>	<i>In Australia Godfrey Hirst reduced a number of wool prices permanently by \$5.00 per metre</i>
<i>27 April 2004</i>	<i>BP5 003671 @ 3695</i>	<i>Australia Commercial "Pressure on margin will be evident over the next few months as our major tufter and woven competitors compete for volume"</i>
<i>27 April 2004</i>	<i>BP5 003671 @ 3688</i>	<i>"It was a terrific effort considering Godfrey Hirst had their warehouse sale at this time"</i>
<i>27 April 2004</i>	<i>BP5 003671 @ 3689</i>	<i>Opposition Activity: "Godfrey Hirst continues to be a concern and seem to be falling back to their bad old ways. Although their approach enabled our first placement of solution dyed nylon and stainmaster into Carpet Court and Andersen's."</i>

Carpet Call

- 19.29 There was a further cause for concern with potential to bear on those same aspects of the revenue assumption for FY04 and also the projection for FY05, and whether the forecast FY04 and projection FY05 were reasonable.
- 19.30 Key customers were important to Feltex, such that prospectus, under Key Investment features, stated³³⁹

“Feltex has continued to expand its relationships with key customers and suppliers and has significantly increased its customer service levels” and under Investment features is stated³⁴⁰ *“Feltex has continued to expand its relationships with key customers and has significantly increased its customer service levels. As a result of these strategies, on-time deliveries and customer satisfaction levels have all demonstrably improved.”*

By customers, in the retail market, it meant retailers, whose³⁴¹ “recommendations can have a significant influence on the style and brand chosen by the consumer.” The “What are my risks section” discloses the following:³⁴²

*Key relationships with customers and suppliers
Feltex's business and growth opportunities are dependent on key customer relationships (a small number of whom make up a large proportion of Feltex's revenues), and key supplier relationships ... Feltex is not aware of any impending issue that may lead to the termination of, or adverse changes to, any of these relationships. Changes to these relationships could have a material adverse effect on Feltex's results or financial position.*

- 19.31 Carpet Call was a key customer. Feltex sold carpet to it, and owned 50% of its shares, a matter referred to in the prospectus under Business Description, in which it described Carpet Call as

“... one of the best-known carpet retailers in Australia. Carpet Call operates throughout Australia under the Carpet Call and Solomon brands.”

It was one of Feltex's largest customers, if not the largest, with \$19 million in

339 Prospectus, pp 7 and 41
340 Prospectus, p 16
341 Prospectus, p 37
342 Prospectus, p 128

purchases annually.³⁴³ Sales by Feltex to it bought in revenue, as did Feltex's shareholding.

- 19.32 Feltex's consolidated statement of prospective financial performance³⁴⁴ reports the forecast FY2004 net surplus attributable to shareholders of \$10,133,000. Of that, \$1,400,000 (13.8%) was derived from the retained surplus of associated companies, namely Carpet Call.³⁴⁵
- 19.33 Carpet Call's principal was Mr Jim Smith, with whom Feltex had a strained and deteriorating relationship. Mr Meredith reviewed documents bearing on the relationship between Jim Smith and Feltex,³⁴⁶ which include a memo from Mr Feeney to the Board headed "Carpet Call – Some early observations of the relationship":³⁴⁷

At my first board meeting, Jim Smith was, according to Michael and Russell Martin, "well behaved". Seeing as the entire one and half hour meeting consisted of Jim, Michael and Russell arguing over the history, present and future of the Shaw Carpet Call relationship, a meeting when Jim is not "well behaved" should be a sight to behold.

- 19.34 It is apparent from an email of 5 December 2003 from Mr Thomas to Mr Millard that he also had concern about the relationship:

Second, as you may recall we have a 50% interest in Carpet Call, one of the largest carpet retailers in Australia. This investment (it is actually a share interest, but we consider it more of a JV type investment) paid us our first dividend in 2003 FY of AUD 250,000. Our relationship with the other shareholder, who is the CEO, Jim Smith, is very "hot and cold." Frankly, I think Jim is a whacko (as does the Feltex Board) with quite irrational behaviour at times. His budgeted pre tax profit this year is AUD 3 million. We have had an approach to sell our interest at about AUD 10 million. We are favourably inclined to do this--it would get us right out of retail, which would be favourably received by the rest of the retail trade, who can be suspicious, at times, of our trading relationship with Carpet Call given our investment in the company. Cash would pay down debt. The "interest in an associate company" does not really attract any stronger potential market capitalisation in a potential IPO given the low dividend yield and our lack of absolute control over the investment.

343 DD1 000534 @ 000537. In his interview with the Due Diligence Committee Mr Lyons advised that Carpet Call had the highest annual revenue at A\$19m. This was attributed in part to Mr Lyons treating Carpet Court NSW (A\$18m) and Carpet Court Victoria (A\$13m) as separate customers.

344 Prospectus p 85

345 Prospectus p 47

346 Meredith BOE [90] – [93], [128] – [131]

347 CB2 001768

- 19.35 In the latter half of 2003 Feltex sought to remove a bank guarantee it had provided to the ANZ bank for the benefit of Carpet Call. Carpet Call opposed that³⁴⁸ yet Feltex persevered. On 14 November 2003 Mr Tolan wrote to ANZ Bank seeking withdrawal,³⁴⁹ an action supported by the board.³⁵⁰ It appears from a memorandum of 30 January 2004 from Mr Magill to the directors of Feltex that Mr Smith was unhappy with that, however a release from the guarantee as at 1 April 2004 was agreed to.³⁵¹
- 19.36 This did not assist the relationship between Feltex and Carpet Call. Carpet Call's purchases from Feltex were declining. The May 2004 Group Operating Report stated: "*Carpet Call who had their worst month ever, was a major contributing factor. Jim Smith is not giving us any support whatsoever.*"³⁵² By way of memorandum of 5 October 2004 to the board Mr Magill wrote:³⁵³
- Over the last 3 years we have had numerous discussions during the Board meetings in relation to our retail investment, and our trading relationship with Carpet Call; despite our best endeavours it appears that Jim Smith is determined to continue to move business from Feltex Carpets. I attach the details of his sales performance over the last two years which show a reduction in Carpet Call and Solomon's purchases of Feltex products. I also attach a recent document from Carpet Call's Queensland State Manager where he has communicated to Solomon's franchisees that we are an unreliable supplier of our polypropylene product Kings Domain. At the time of this communication we had ample stocks and this statement is incorrect. This demonstrates the negative attitude within the Carpet Call business to Feltex.
- 19.37 He included extracts from the Group Sales Report which record the month by month sales for Carpet Call & Solomons to September 2004.³⁵⁴ As can be seen the combined purchases of Carpet Call and Solomons from December 2003 have decreased every month against the previous years purchase. This trend is consistent with the timing of the removal of the guarantee of Carpet Call's banking facility; it is a reasonable inference that the removal contributed to the decline.
- 19.38 Feltex ought to have disclosed to shareholders in the prospectus that it had a difficult relationship with their largest residential customer, in which they owned a 50% interest.

348 BP4 002957 @ 003071

349 BP4 002957 @ 003070; included in the papers for the Board meeting of 1 December 2003.

350 BP4 002957 @ 002964

351 CB8 005909

352 BP5 003820 @ 003871

353 CB18 013105

354 CB18 013105 @ 013106

- 19.39 The combination of increased competition from Godfrey Hirst and the deteriorating relationship with Carpet Call meant that the revenue assumption that there would be no change in demand and existing customers would continue to trade at current levels was not reasonable. The same applies to corresponding assumptions for the projection for FY05.
- 19.40 In summary thus far, by 2 June 2005, and in some cases earlier, the following problems were apparent:
- (a) Sales revenue for January, February, April and May 2004, and the second half year performance to those months, was significantly down against the corresponding periods in the previous year;
 - (b) Sales volume for January, February, April and May 2004, and the second half year performance to those months, was significantly down against the corresponding periods in the previous year;
 - (c) Market share had been lost in 2004, a matter presented to the Board and Due Diligence Committee on 7 April 2004, despite the strategy for that year having as its objective gaining market share;
 - (d) The forecasts for April 2004 and May 2004, for both sales revenue and volume, were not achieved by a substantial margin;
 - (e) In the nine months to March 2004 Feltex had only achieved growth in sales (revenue) of 2.39%;
 - (f) The total operating revenue for FY 2004 was to be missed by \$7.5 – \$9 million;
 - (g) there was increasing competition, especially from the main competitor, Godfrey Hirst and a relationship with a key customer was deteriorating.
- 19.41 Yet Feltex had issued and proceeded to allot on the basis of a prospectus that relied on growth of 12.75% for April, May and June 2004; and contained positive representations as to revenue and growth and related assumptions.

19.42 Professor Robb considered that disclosure of the shortfall would have materially affected investment decisions: **355**

I consider that had the 2004 forecast revenue figure of \$335.498m been revised in May 2004, when it was known or ought to have been known by Feltex that the 2004 forecast revenue figure was unrealisable [DD2 000751 at 753], by way of an announcement to the NZX or by way of a supplementary prospectus, investors would have seriously questioned Feltex's ability to realise the 2004 forecast and certainly the 2005 projected financial figures. I consider that such a disclosure would have materially affected their decision of whether or not to invest in Feltex.

19.43 Mr Lim considered that in his experience, “investors, whether sophisticated or not, examine closely a company’s revenue figures and are interested in sales trends.”**356** Brian Russell gave expert evidence in respect of the FY2004 revenue shortfall:**357**

24. *It is not unusual for sales forecasts to be missed and at first blush a shortfall of \$7.7 million may not necessarily be material. However, what is unusual is that this shortfall occurred within the first reporting period after the publication of the prospectus, and what is even more unusual is that the forecast period between the publication of the prospectus on 5 May 2004 and the balance date of 30 June 2004 was so short, a period of only 56 days.*
25. *In those circumstances I would have expected that the forecast sales for the year to the end of June 2004 would have been based on actual sales to the end of April and with a readily achievable forecast for May and June 2004 (ie not a stretch target unless that was clearly stated in the prospectus). Furthermore I would have expected that senior management would have been designated the task to continue to closely monitor actual sales and sales trends right up to the publication of the prospectus and during the prelisting period and immediately report any material divergences to the Due Diligence Committee. I consider this is consistent with my view that the market's expectation would be that forecast sales would be comfortably exceeded. As a professional adviser to vendors and promoters, I have advised that any forecast sales in a prospectus had to be readily achievable and based on actual sales.*

19.44 Logically, the same applies to those problems individually and cumulatively. They were material adverse circumstances that ought to have been

355 BOE Robb [19]
 356 Lim BOE [38]
 357 Russell BOE [24] – [25]

disclosed and would bear on investment decisions, because of their bearing on the forecast for FY04 and projection for FY05.

The due diligence process

- 19.45 The adequacy of the due diligence process and the reasonableness of the resulting decisions must be assessed having regard to the information that was available. The data showing the problems outlined was available to the defendants in their various roles, including as a result of their involvement in the due diligence process.
- 19.46 The quantum of the problems outlined exceed significantly the materiality threshold of \$500,000 set by the Due Diligence Committee.**358**
- 19.47 On the 4 May 2004, the Due Diligence Committee met for the purpose of confirming that no material adverse circumstance had arisen thus enabling registration and distribution of the prospectus.**359** It appears from the minutes that the factors outlined, insofar as they were available, were not addressed.
- 19.48 This despite the minutes of the Board meeting of 27 April 2004 recording: *“April is forecast to be a difficult sales month but the shortfall will be picked up in May and June”*. **360** Mr Saunders, Mr Thomas, Mr Kokic and Mr Tolan, all members of the Due Diligence Committee, were present.
- 19.49 Not addressing that data occurred despite the prospectus stating, on page 88, that:
- The forecast was prepared as at 4 May 2004 for use in this Offer Document.
- 19.50 The prospectus was registered. On 2 June 2004 at 7am the Due Diligence Committee convened for the purpose of confirming no material adverse circumstance had arisen and to conduct bring down due diligence.
- 19.51 The revenue shortfall was discussed. An earlier section has already touched on the problem with the approach taken to the shortfall at the meeting. It was analysed against a 12 month timeframe yet arose in the context of a 3 month

358 DD1 000007 @ 000011
 359 DD2 000747 @ 000748
 360 BP4 003345 @ 003348

forecast. The SIP grant forecast of NZ\$4.7 million was also taken into account. Professor Robb stated:

...There is no valid reason for annualizing the shortfall as it occurred in the three month period that increased sales of about NZ\$10,4 million were forecast to be achieved [CB12 008844 at 8859], the company having only increased sales by A\$4.1 million by March 2004 [DD1 000221 at 222]361

and

Further I note that Feltex anticipated a shortfall, on 2 June 2004 [DD2000751 at 754], of between \$7,500,000 and \$9,000,000. Feltex was forecasting increased growth of 12.75% (\$10,358,000) in sales over the fourth quarter, then the anticipated shortfall equated to Feltex missing the forecast growth by 72.4% to 86.9%. I consider that this is a material adverse circumstance that should have been disclosed by the issue of a supplementary prospectus. [CB1 000566; CB12 008844]362

and that

I consider it cynical on the part of the defendants to accept Mr Magill's view that as forecast EBITDA will be achieved that a shortfall in sales need not be disclosed to the market, especially when the SIP grants of \$4.7 million goes straight to the bottom line.363

- 19.52 Regardless of whether it was cynical or a lack of reasonable care, the result was the same. The underlying data was not called for and analysed. No inquiry was made beyond those referred to in the minutes.
- 19.53 The Due Diligence Committee simply accepted oral assurances by Mr Magill and Mr Tolan (who relied on Mr Magill)364 that June 2004 would be a strong month. Reliance on oral answers was unsatisfactory. As recently as 27 April 2004 Mr Magill had stated that the April shortfall would be “*picked up in May and June*”,365 yet May was by 2 June 2004 known to have been a poor month.
- 19.54 Mr Tolan confirmed that the daily sales report, which contained some information about forward orders,
- “is one of the factors you consider when you are assessing sales for the month or forecast period, it’s one of the factors” 366*

361 Robb BOE [35.1]
 362 Robb BOE [35.7]
 363 Robb BOE [35.8]
 364 DD1 000751 @ 000753
 365 BP4 003345 @ 003348
 366 NOE page 1699, line 30 to page 1700 line 33

but that it wasn't a 100% indication.**367** As Bell Gully advised the Securities Commission in its letter of 15 September 2005

“outstanding order records do not provide a particularly reliable indication of future sales performance...”.**368**

- 19.55 At 7.00 am on 2 June 2004 there cannot have been much certain known about June 2004 performance, and certainly not sufficient to allot a \$250 million share issue.
- 19.56 The defendants assert reliance on expert advisors, all of whom qualified their opinions. The legal advisors did not address financial matters. Ernst & Young did, but the extent was limited. Their report of 28 April 2004 to the Due Diligence Committee states that they reviewed the forecast and related assumptions upon which the forecast was based,**369** but that the review was substantially less in scope than an audit.**370** The assumptions underlying the forecast were developed by management **371** and Feltex (ie the Board) retained responsibility for the information provided. A negative assurance was given, consistent with a review but not an audit.
- 19.57 The extent of the information with which Ernst & Young were provided for the purpose of their opinion is not known. As importantly, there is no evidence that they were provided with new information post 28 April 2004 and asked to review the appropriateness of the forecast for FY04 and for projection FY05 having regard to new information.
- 19.58 Reliance on professional advisors participating in the due diligence process does not avail the defendants for two further reasons. First, it does not appear from the minutes of 2 June 2004 as though proper inquiries were made by those defendants. Secondly, it does not appear from the same minutes as though the defendants put before the committee the problems

367 NOE page 1702, lines 21-26

368 CB1 000047 @ 000093. See (Tolan) NOE page 1699, line 5-11

369 DD2 001002 @ 001015

370 Ernst & Young state “The procedures we followed in our review of the Forecast, and our review of the compilation of the Projection, are substantially less in scope than an audit conducted in accordance with generally accepted auditing standards in New Zealand. Accordingly, we do not express an audit opinion on the Forecast or Projection. In addition, we do not express any opinion on the quality or effectiveness of the Company's internal controls.”
DD2 001002 @ 001006

371 DD2 001002 @ 001015

identified here, aside from the fact of a revenue shortfall in April and May 2004, but without sufficient reference to the actual extent of it.

Significance of the actual June 2004 performance

- 19.59 The actual performance in June 2004 is irrelevant to the issue of the reasonableness of the forecast for FY04, occurring as it did post allotment.

Conclusion

- 19.60 Feltex had many problems that meant that the forecast for FY04 and revenue assumption on which it was based were not reasonable. Their inclusion in the prospectus was misleading or deceptive or likely to mislead or deceive. It was also negligent.
- 19.61 There was sufficient information to place the defendants on notice of the need to make or initiate proper inquiry, and issue an amendment to the prospectus. They did not, but continued with allotment on 2 June 2004. The failure to do so was the result of negligence.

20. Projection 2005

- 20.1 Problems with the projection FY05 and assumptions are pleaded in 4ASOC:
- 34: Schedule 1A, prospectus p 7, was misleading for the reasons as to why Feltex was claimed to be a good investment based on its trading history and existing and potential earnings. Those included the projected EBITDA of \$52 million for FY05, an increase of 13% on the forecast EBITDA;
- 37: Schedule 1C, prospectus p 11, was misleading as to the price/earnings ratio and projected gross dividend yield for FY05. The stated NPAT (pre-goodwill amortisation) of \$25.9 million for FY05 and the price /earnings ratio pre-good will amortisation were not reasonably achievable;
- 44: Schedule 1K, prospectus p85, was misleading. The projected net surplus attributable to shareholders of \$23,899,000 and projected net surplus attributable to shareholders (before amortisation, write-offs and early redemption amount) of \$25,873,000 were not reasonably achievable;
- 46.1-5: Schedule 1 M, prospectus p 90. The general assumptions underlying the projection for FY05 were misleading. They include no change to the competitive markets, no change to the import of carpets, relationships with retailers remaining unchanged and strategies being

successfully implemented to increase market share by approximately 1%;

64.6-6: Prospectus pp 19 and 85. The projected sales for FY05 of \$348,147,000 were not capable of being met having regard to the practice of accelerated sales, the declining trajectory of operating revenue (sales) for FY02 and FY03 and the true figure for FY04 and increased competition from imports as a result of the 1 January 2005 tariff reduction and free trade agreements.

71 Schedule 1K, prospectus 85. Implied assumptions underlying the projection that there would be no significant change in pricing policy of competitors by discounting and no change to the level of imports of carpet were misleading,

20.2 As with the FY04 forecast, the FY05 projection was a fundamental feature upon which Feltex was sold. It featured prominently in the prospectus, first on page 7, in which it was made clear that the forecast FY04 and projection FY05 were linked. The latter built upon the former:

Feltex is projecting EBITDA of \$52 million in FY05, an increase of 13% on forecast EBITDA (on a pro-forma basis adjusted for one-off items) of \$46 million in FY04. The FY04 forecast proforma EBITDA is, in turn, an increase of 48% on EBITDA of \$31 million in FY2003. Feltex is projecting dividend payments that imply a gross dividend yield of 8.6% - 9.6% in respect of the financial year ending June 2005 (to be paid in March 2005 and October 2005).³⁷²

20.3 The prospectus, page 85, projected total operating revenue \$348,147,000 and a net surplus attributable to shareholders of \$23,889,000. ³⁷³ The projection, in skeletal form, was included on page 19. As with the forecast for FY04, the net surplus attributable to shareholders was missing. Instead there was included a NPAT (before amortisation, write-offs and early redemption amount) of \$25,873,000. That page did not include reference to SIP grants being included in revenue.

20.4 As with the forecast for FY04, a key element was the total operating revenue. It was the top item on pages 19 and 85. Page 19 included the actual and prospective revenue for the years FY02 to FY05, allowing potential investors to observe the change in revenue, past and prospective. Page 85 placed the revenue projection for FY05 alongside the revenue forecast for FY04, again allowing observation of the change.

372 Prospectus p 7
373 Prospectus p 85

20.5 The projection was based on assumptions, included in Schedule 1M, pg 90-91 of the prospectus, including:

- no change to the economic or regulatory environment;
- exchange rates for NZ\$ and US\$ at a certain level, with an assumption that hedging contracts to December 2004 will be exercised;
- no change to the competitive environment, including the pricing of competitors, the competitive market and importation of carpet;
- no material change to the industry conditions, including an assumption that the size of the New Zealand and Australian markets measured by volume will increase over the projected period by approximately 1%;
- no adverse developments with any material retailers;
- as to revenue, the market growing as described under industry conditions (ie 1% by volume) and Feltex successfully implementing strategies resulting in its market share increasing by approximately 1% over the projected period. No change in the selling prices of carpet was assumed.

20.6 The assumptions were preceded by a statement that they be read in conjunction with the risks section on pages 125 – 130, and that the prospective financial information for the year ending June 2005 constitutes a projection:

*... as defined In New Zealand Financial Reporting Standard No. 29 ... and has been prepared on the basis of a number of hypothetical but realistic assumptions that reflect possible courses of action **that the Directors reasonably expect to take as at the date the information was prepared.** A projection is not a forecast. **The projection was prepared as at 4 May 2004** for use in this Offer Document. [Emphasis added]*

20.7 The emphasised words are important. First, they convey the concept of reasonable expectations of the directors, who would be taken to be prudent. Secondly, they convey the impression that those reasonable expectations

will be based on information available up to 4 May 2004. A prudent director would not ignore information available up to the date stated.

Preparation of the projection

- 20.8 Mr Tolan gave evidence that the process for preparing the forecast for FY04 was similar to that for the budget, save that it used 9 months of actual figures to March 2004, and that the projection for FY05 was more similar to a usual budget in that it was entirely a projection of future performance, ie it did not have 9 months of actual figures.³⁷⁴ He stated that³⁷⁵

“... we applied the same rigour to the preparation of the 2005 projection figures as we did to the 2004 forecast figures.”

- 20.9 Given the similarity in processes and rigour, if the forecast for FY04 was wrong in any significant respect, especially given the forecast portion was only the three months of April, May and June 2004, then that could reasonably be expected to mean that the projection for FY05 may very well suffer from the same issue and should be revisited.

The reasonableness of the projection

- 20.10 Mr. Meredith approached the issue of whether the projection was reasonable on the basis that:³⁷⁶

... if the assumptions are found to be unreasonable, then it follows that the projected FY05 results (including operating revenue and profit) would also be.

- 20.11 These are referred to below, but there is a first step, which is to consider how the projected sales revenue and volume were calculated and whether they were well founded. As seen earlier, the projection for FY05 was based on an increase in sales revenue from FY04 of 4.7% and in sales volume of 5.1%. By April and May 2004 sales revenue and volume were both down substantially to the extent earlier identified. By 2 June 2004 a shortfall in revenue of \$7.5 - \$9 million was anticipated.
- 20.12 This was significant and, given the similarity in process and rigour for the forecast for FY04 and the projection for FY05, reassessment ought to have

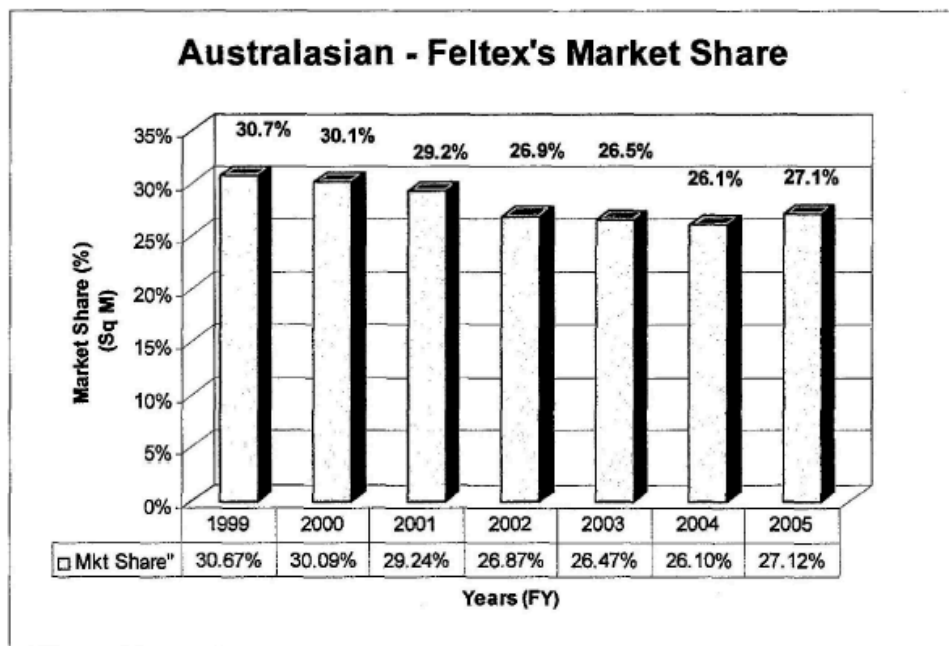
374 Tolan BOE [22]

375 Tolan BOE [23]

376 Meredith BOE [246]

occurred. The starting point of the uplift of 4.7% for sales revenue and 5.1% in volume should have been lower, and the projection recalculated. In addition, the achievability of those recalculated figures should have been reviewed.

20.13 Secondly, the assumption that Feltex would grow market share was not reasonable, a view that reflects common sense and was also stated by Mr Meredith. **377** As shown in the Volume section, by April 2004 Feltex was known to be suffering its sixth consecutive year of loss of market share, despite having planned to grow market share. See the bar chart *Australasian – Feltex’s Market Share*. **378**



CB007845

20.14 Thirdly, the assumptions that there would be no change to the competitive environment and industry conditions were not reasonable. As seen in the forecast for FY04 section, competition was increasing, in particular from Godfrey Hirst. That had been reflected in the Board papers that pre-dated the prospectus.

377 Meredith BOE [243]
 378 CB11 007831 @ 007845

20.15 More change in the competitive environment and industry conditions was about to occur. Prior to allotment it was known that raw material prices were increasing and that Feltex was to respond to that by increasing prices on 1 July 2004. This was not disclosed to the market, despite the impact on that environment and those conditions, and the impact on the assumption that Feltex would grow market share. Instead the prospectus contained an assumption:³⁷⁹

It is assumed that to the extent that raw material costs increase during the projected period, there would be a corresponding increase in carpet selling prices (noting that the projection does not assume any carpet selling price increases), resulting in a neutral earnings effect.

20.16 Implicit in the wording is that Feltex was not planning to increase its selling prices and was not aware of any impending raw material price increases. Yet it was known that raw material costs would rise. Ernst & Young's report to the Due Diligence Committee of 28 April 2004 (presented by John Shakleton, who was interviewed by the Due Diligence Committee on 31 March 2004³⁸⁰) stated:³⁸¹

³⁷⁹ Page 91 of the prospectus
³⁸⁰ DD1 000598
³⁸¹ DD2 001002 @ 001021

2.3 Cost Increases

In John Shakleton's presentation he noted that costs were at risk of rising by the following estimated percentages:

- Dye/Chemicals [CPI or slightly above]
- Masterbatch (polypropylene additive) [CPI]
- Primary/Secondary backing [CPI, but there is USD exposure on these supplies]
- Wool [5-10%]
- Utilities [8% reduction in Australia, offset by 15% increase in New Zealand]
- Gas [up 5% in Australia, 25% in New Zealand]
- Water [5% increase]
- Synthetics [4-10% over next year, with risk around USD]

These anticipated price rises have not been built into the projected profit and loss / cash flow for the year ended 30 June 2005.

Discussion with executive management indicated that these estimates were not firm views of the management team but were rather an indication of the potential rises that may occur and that were at risk of occurring.

In addition, management believe that should the price of supplies rise by these values then this will impact on the whole industry and therefore Feltex will be able to increase sales prices to offset the price increases in supplies. An assumption to this effect has therefore been included in the Prospectus.

The DDC should formally endorse the position taken by management in regards to the above assumption.

- 20.17 The minutes of the bring down Due Diligence meeting of 2 June 2004 record, under General Discussion, that a price increase was to be implemented: **382**

Projections - the price increase should increase sales by approximately \$8 million. The Company's strategy not to discount will continue and the revenue line should be protected. The price increase is as a result of anticipated raw material increases in the new financial year.

- 20.18 Fourthly, but associated, the assumption that there would be no change to the importation of carpet was not reasonable. The tariff changes Scheduled for 1 January 2005 had potential to (and as it happened did) result in increased imports and competition in the market in which Feltex operated. The effective barriers stated to exist on page 127 of the risks section were more apparent than real. As an example, the "Shaw Product Representation

*Agreement, which give Feltex the ability to important carpets from Shaw Industries, Inc. at competitive wholesale prices*³⁸³ was not utilised, because it seems from Mr Thomas the currency rates would need to be significantly higher for it to assist.³⁸⁴ No evidence was produced to show how a product broking arrangement would help cover high base level overheads. Mr Meredith considers the assumption to have been unreasonable.³⁸⁵

- 20.19 Fifthly, the assumption that there would be no adverse developments with any material retailers was misplaced. As seen in the sales revenue section, some months prior to the IPO the relationship with Carpet Call (Mr Jim Smith) had begun to deteriorate and substantially fewer carpet was being ordered. As Feltex's single largest retailer, in which Feltex had a 50% shareholding, this was clearly material.
- 20.20 The defendants cannot shelter behind professional advisors in respect of the problems with the assumptions. They were responsible for them. Ernst & Young's report of 28 April 2004 to the Due Diligence Committee expressly stated, in respect of the projection, that "*...we have not reviewed the validity of the assumptions*".³⁸⁶
- 20.21 There is evidence of the directors questioning assumptions in a meeting of 8 April 2004,³⁸⁷ prior to registration of the prospectus, but the minutes lack detail. The nature and extent of the questioning is not known. As an example, Mr Thomas³⁸⁸ was asked what was questioned in that meeting but he could not recall. However, the problems with the assumptions and the documentation showing those were such that proper inquiry was very likely have led to revision of the assumptions.
- 20.22 There is no evidence that the validity of the assumptions was revisited subsequent to registration but prior to allotment, following more concerning sales data for April and May 2004 being available. Indeed, the April Data should have been available to Mr Magill and Mr Tolan prior to registration of the prospectus.

383 Prospectus p 127
 384 Thomas NOE1327 line 5 to 12
 385 Meredith BOE [224] – [227]
 386 DD2 001002 @ 001028
 387 Tolan BOE [28]-[29]; Thomas BOE [87]
 388 NOE page 1426, line 8 - 22

Known problems

- 20.23 To the problems with the assumptions need to be added the known problems, eg with revenue, volume, the achievability of the forecast FY04, lean manufacturing and forward-dating covered in elsewhere in this submission.
- 20.24 Another problem not yet covered relates to the ability to produce wool or wool mix carpets. Two SESS tufters were purchased in FY03 for “sew off” in Melbourne by the end of June 2003. **389** In fact only one SESS tufter was received in FY2003. It is apparent from the 8 April 2004 presentation to the Due Diligence Committee and the Board that the prospective increases for wool/wool mix carpets was to come from those SESS tufters.**390**
- 20.25 However, only 21 days after the decision to allot, an order was initiated for over \$8 million for the purchase of three tufters, including a second SESS tufter. On 24 June 2004**391** Mr Feeney emailed the Feltex board concerned about the lack of disclosure of that additional capex in the prospectus stated:

Barely three months later we are presented with an urgent need for three tufters with a frankly scant marketing and sales justification.

- 20.26 The capex requests described Tufter A as being sought at a CER cost of AUD \$4,061,840,**392** the purpose being to free up capacity on Tufter #57 to service stock ranges.**393** In short, the there was insufficient existing capacity. The new tufter was known as tufter 61. Tufter B was sought at a CER cost of AUD \$2,830,360.**394**
- 20.27 On 17 November 2005 the capex for the SESS tufters was reviewed for the ARMC**395**. Tufter 57C, being tufter 57 referred to above, and Tufter 61 (the new tufter), had failed to exceed 44% utilization at any time in the forecast or projection periods, except for May 2005 (55.1%) and June 2005 (47.9%) Production metres from Tufter 57C were around 2,500 metres per month in the forecast period to June 2004 and peaked at 7,913 metres in November 2004 before dropping to 2,122 metres in December 2004 and remained below that level until May 2005. Tufter 761 was not commissioned until March 2005.

389 BP2 01678 at page 1775 Feltex Project Review Update 14 March 2003 by Mr Bennetts
 390 CB 11 07831 @ 007834 and 007835
 391 CB 17 012491
 392 CB 17 012491 @ 012492
 393 CB 17 012491 @ 012494
 394 CB 17 012491 @ 012505
 395 CB19 014086 @ 014095 to 014099

- 20.28 The problem was that neither of the SESS tufters, were suitable for the production of woolen or wool mix carpet.³⁹⁶ In FY 04 the original SESS tufter (57) generated only AUD\$868,602 in sales revenue whereas it was forecast to make \$1,385,000 from woolen carpet alone. In FY05 it generated AUD\$3,986,902 in sales revenue whereas it had been projected to make AUD\$7,178,000 from woolen carpet alone.³⁹⁷
- 20.29 The cumulative effect of all the problems was a projection for FY05 that was made, and confirmed by way of allotment, on an entirely erroneous basis.
- 20.30 The cumulative weight of those problems is substantial. It is clearly an inadequate answer to say the focus was on increased margin. Analysis has not been provided by the defendants as to how, on 5 May 2004 and through to 2 June 2004, it was reasonably thought that margin would carry the day. As is clear, it did not do so.

The consequences

- 20.31 The consequences of the problems above, individually and cumulatively, logically include the FY2005 projected sales revenue, volume, EBITDA, EBIT and NPAT not being reasonably achievable. They also reflect adversely on Feltex's purported strategy.
- 20.32 Those consequences were borne out following allotment. The monthly volume, revenue and margin for projections for FY05 were contained in a "Projected Operating Statement for the year ended June 2005".³⁹⁸ It included the following, which are extracted from it and then added to give subtotals for July to November 2004.

	Projection Jul-04	Projection Aug-04	Projection Sep-04	Projection Oct-04	Projection Nov-04	Projection Dec-04	Subtotal Jul04-Nov04	Subtotal Jul04-Dec04
Carpet Volume (m2)	1,457,806 m ²	1,514,018 m ²	1,589,600 m ²	1,761,544 m ²	1,672,149 m ²	1,384,281 m ²	7,995,117 m ²	9,379,398 m ²
Net Sales - B	28,181	29,177	30,631	33,910	32,224	26,783	154,122	180,905
Net Margin	9,127	9,465	9,933	10,995	10,445	8,670	49,965	58,635

396 CB20 014554 @ 014556

397 Horrocks NOE 2256 line 27 to line 2261 line 12.

398 CB 12 008860 as confirmed by Mr Horrocks, NOE 2353, 4-7. It is noted some of the detail differs from that in CB 13 009725, NOE 2353 24-30, but not in the respects extracted.

20.33 That data is then compared with the actual performance, shown in the “Income Statement for the Period Ended November 2004”. 399 Mr Horrocks accepted that by November 2004 when compared with the projection, 400 Feltex was:

- (a) 1,109,000 m² down on volume (or 13.9%);
- (b) NZ \$21,767,000 down on sales (revenue), (or 14.1%);
- (c) Down on net margin as well. The margin revenue of \$44,385,000 was \$5,580,000 or 11.2% below projection.

20.34 By 31 December 2004, only 6 months after allotment, Feltex was behind the projected revenue target for 1HFY05 by \$21,253,000. The final result for FY05 was a net surplus attributable to shareholders of \$11,750,000.⁴⁰¹ This was not inconsistent with Feltex’s volatile earnings history.⁴⁰²

Year	Net surplus (\$000)
July 1999 (12 months)	5,246
June 2000 (11 months)	2,607
June 2001 (12 months)	(13,181)
June 2002 (12 months)	(18,283)
June 2003 (12 months)	6,841

20.35 The reasons advanced by the directors have already been addressed, and include many of the problems pleaded. The first defendants have sought to place most of the blame on the economic cycle and cost increases. Those will likely have contributed to the extent of the loss. However, that does not detract from the fact that the problems referred to in these submissions were apparent before the IPO, and continued after and Feltex as represented in the prospectus should have been able to cope with those.

Conclusion

20.36 The projection for FY05 and the assumptions on which it was based were not reasonable. It, and the resulting projected sales revenue, EBITDA, EBIT and

399 BP6 005007, Horrocks NOE 2355 In 10ff.

400 Horrocks NOE 2355 In 10ff

401 CB19 013887 @ 013906

402 Prospectus p93

NPAT, were not reasonably achievable. Potential investors were likely to be misled or deceived by the related representations in the prospectus.

20.37 There was sufficient information (as is apparent from other topics) to place the defendants on notice of the need to make or initiate proper inquiry. The defendants did not do so, but continued with allotment on 2 June 2004.

20.38 These arose from negligence.

21. Foreign exchange risks

21.1 4ASOC para 58 pleads that the prospectus failed to disclose that there was a NZ\$ / AU\$ exchange rate risk,

“specifically that each one cent rise in the cross-rate between the New Zealand dollar and the Australian dollar would affect the profitability of Feltex by approximately NZ\$550,000”.

21.2 This section looks at that particular risk, but also the structure and style of the risks section of the prospectus. Matters that bear on disclosure of tariff and import risks are dealt with separately.

21.3 The exchange risk is disclosed on page 126 of the prospectus. By the time potential investors read the risks section they will likely have read the earlier, selling parts of the prospectus, without which the risks would lack context. They are thus likely to reach it with a very positive impression.

21.4 It is against that impression that the adequacy of disclosure of risks needs to be weighed. Disclosure must be sufficient, and worded sufficiently clearly, to meaningfully and effectively convey the true risk to a reader who has first seen those parts referred to above. This is consistent both with common sense and the SA s34(1)(b), which recognises that a prospectus may be

“... false or misleading in a material particular by reason of failing to refer, or give proper emphasis, to adverse circumstances”

21.5 That may mean quite strong language is required. The information and analysis required to obtain a true picture, and the discipline to cast aside first

impressions, may be reposed in sophisticated investors, such as brokers and market analysts, but this is much less likely in the case of retail investors.

- 21.6 While the risks section is one of the eleven sections of the prospectus to which readers are directed on p1 of the prospectus, it is presented under a heading part way down on p125: “*What Are My Risks*” and continues through to p130, occupying only 6 pages. It is not prominently presented nor positioned early in the prospectus.
- 21.7 The topics covered in the risks section range from industry to regulatory. From their language and grouping it is unclear whether one risk is greater than the others or whether its impact if realised may be more severe than another.
- 21.8 The style in which the risks section is written deserves mention. A substantial part of the section provides generic information. Risks are stated, but their significance, probability and potential impact are not meaningfully addressed and in most cases mitigating factors are referred to.
- 21.9 These issues are apparent from the disclosure of the risk of exchange rate fluctuations:

Exchange Rate fluctuations

In addition to the possible impact on imports (described below), exchange rate fluctuations impact the cost of Feltex’s imported raw material purchases (primarily nylon, polypropylene and backing materials) which are predominantly denominated in United States dollars. An appreciation of the United States dollar against the Australian dollar and/or New Zealand dollar would increase Feltex’s cost of raw materials. Feltex has a partial natural hedge to movements in the United States dollar via its export carpet and wool yarn sales to the United States which are denominated in United States dollars.

Feltex’s principal sales market is Australia. Any appreciation in the New Zealand dollar against the Australian dollar adversely impacts the margin of Feltex’s New Zealand manufactured woollen product sole in the Australian market. Feltex’s major competitors have manufacturing plants in New Zealand and are subject to similar exchange rate risks. As Feltex also remits funds from its Australian business to New Zealand, Feltex is also exposed to movements in the Australian dollar / New Zealand dollar exchange rate.

Feltex’s exchange rate exposure is reviewed on a regular basis. In almost every circumstance where currency exposures arising from operating costs and revenue are certain, it is Feltex’s policy to hedge

these risks as they arise. For those currency exposures which are less certain as to timing and extent, such as future sales and purchasers, it is Feltex's current policy to cover a maximum of 50% of the anticipated exposures for a period of six months forward with the balance of such exposure reviewed when it is incurred.

*There can be no assurance that changes in exchange rates will not have a material adverse effect on Feltex's results or financial position.***403**

- 21.10 As can be seen, that disclosure lists several different types of exchange rate risk, including, in the last sentence in the second paragraph, the risk the adequacy of the disclosure of which is challenged in 4ASOC para 58:

"As Feltex also remits funds from its Australian business to New Zealand, Feltex is also exposed to movements in the Australian dollar / New Zealand dollar exchange rate."

- 21.11 The significance, potential impact and weighting of that risk, compared with all the other risks in that part, is unclear. Yet, given that the majority of Feltex's business was conducted in Australia from where funds were remitted to New Zealand, the movements in the Australian / New Zealand dollar were important, so much so that the Management Discussion and Analysis at page 82 notes that:**404**

Sales revenue for the second six months of FY2003 remained flat at \$147.3 million, relative to the prior corresponding period. The flat sales were attributable to the strengthening of the New Zealand dollar against the Australian dollar, which reduced the New Zealand dollar value of Feltex's FY2003 Australian sales on consolidation by \$12.8 million ...

- 21.12 However, potential investors are not directed to that page or part of the prospectus, which lies between the "Auditors report" and "Prospective Financial Information" parts. That historical comment neither features prominently in the Management Discussion and Analysis nor does it quantify the risk or indicated its relevance to the prospective financial information.
- 21.13 More importantly, there is nothing to indicate that that part is focussed on risk disclosure. Readers are directed to find about their risks from the part over 40 pages further on titled "What are my risks?" and it is in that part that they ought to find all relevant information about the risks.

403 Prospectus, CB14 010675, p126
404 Prospectus, CB14 010675, p82

21.14 Another feature common to the foreign exchange and other risk disclosures is the use of comforting language and mitigating factors that suggest the risks are more apparent than real. In this case that is reflected in the third paragraph:

Feltex's exchange rate exposure is reviewed on a regular basis. In almost every circumstance where currency exposures arising from operating costs and revenue are certain, it is Feltex's policy to hedge these risks as they arise. For those currency exposures which are less certain as to timing and extent, such as future sales and purchasers, it is Feltex's current policy to cover a maximum of 50% of the anticipated exposures for a period of six months forward with the balance of such exposure reviewed when it is incurred.

21.15 In other words, the risk is almost certainly to be hedged or mitigated. The reader is left with a fairly anodyne statement that:

There can be no assurance that changes in exchange rates will not have a material adverse effect on Feltex's results or financial position.
405

21.16 Readers will certainly not be aware from this language that the A\$ / NZ\$ cross rate risk may affect the Net surplus by (\$1.6 million)⁴⁰⁶ in the projected period (as it did) or that a 1c difference in the NZ\$/A\$ cross affected Feltex's EBITDA by approximately NZ\$550,000 per annum as stated by Mr Saunders in the 2005 AGM.**407**

The second impact was a strong NZ dollar. The NZ dollar was performing strongly against the Australian dollar. In the prospectus we assumed a cross rate of 0.8772 whereas the average rate in March was 0.9289. Each one cent difference effects EBITDA by approximately NZ\$550,000 per annum.

21.17 Yet, it is apparent from the Management Discussion and Analysis that Feltex had experience with the NZ\$/AS\$ cross rate, and from Mr Saunders' address that the effect of a 1c change could be quantified. It ought to have been. This was the view reached by Mr Meredith who, although he could not find a specific requirement to disclose the effect on profit on changes, said in evidence:

However, given Feltex's operations were primarily split between Australia and New Zealand, in my opinion the quantified effect of a change in exchange rates would be something that potential

405 Prospectus, CB14 010675, p126

⁴⁰⁶ CB19 013887 @ 013929 2005 Annual Report

407 Chairman's address (Mr Saunders) to Feltex AGM 1 December 2005; CB20 014401 @ 014405

*investors would be interested in and could readily understand, and therefore should have been disclosed in the prospectus.*⁴⁰⁸

- 21.18 Without that disclosure the exchange rate disclosure was misleading. This disclosure of the risk was inadequate. It failed to properly inform potential investors about a risk that could weigh so heavily on Feltex's reported profit and EBITDA, when they were a major selling point in the prospectus.

22. Tariffs and imports

Tariffs and imports: 4ASOC paras 35.2, 39.16, 39.21, 46, 55/56, 55/57, 64.6.3, 71.2, 72

- 22.1 Although the above sets out discrete tariff pleadings, the tariff pleadings require the overall context to be taken account of. 4ASOC para 72 alleges a failure to have and to disclose a strategy to deal with a number of alleged known or anticipated factors, including tariff reduction, a decline in the market volume of carpet sales in Australia in 2005 – 2007, the change in consumer preferences from carpet to other floorings and an anticipated downturn in the Australian construction / building industry.

Imports risk

- 22.2 In the risks section in the prospectus, at p127, imports are referred to. This is again an example of risks being stated but then some four mitigating factors also referred to, leaving the reader with the impression that imports are not really a substantial risk at all. The first paragraph has a generic statement as to the risk of competition from imports but no information as to the extent to which the various factors referred to could actually affect that risk. There is no reference to the Thailand - Australia Free Trade Agreement. There is a somewhat misleading statement that it is not possible to predict with certainty that scheduled tariff reductions will occur at the rate and within the time periods expected, when the next scheduled tariff reduction in Australia was certain (ie that commencing on 1 January 2005) or very likely to occur, as already announced (that to occur on 1 January 2010).
- 22.3 The mitigating factors are expressed:

Feltex believes that there are a number of factors that act as effective barriers to a significant increase in imports at current exchange rates

⁴⁰⁸

Meredith NOE page 709 lines 24 to page 711 line 16 and BOE para 397

– including the requirement for an effective distribution system, timely availability of product and after sales service.

This then follows:

Feltex's exposure to the importation of carpets made from man-made fibre is mitigated by the Shaw Product Representation Agreement, which gives Feltex the ability to import carpets from Shaw Industries Inc at competitive wholesale prices.

There is then a generic statement of the imports risk:

Although these barriers to entry and this mitigation strategy exists, the import of significant carpet volumes into the Australasian market could have a material adverse effect on Feltex's results or financial position.

- 22.4 There is no meaningful information given as to how serious this stated risk is and certainly no reference to the quite inconsistent submissions that Feltex had made to the Productivity Commission in 2003.
- 22.5 In fact, Feltex faced a significant risk from imported carpets, which is referred to later in respect of the issue of tariffs and increased competition from imports.
- 22.6 None of the first defendant directors, apart from Mr Feeney, appeared to have any clear recollection of the issue of the Productivity Commission submissions made by Feltex in March – June 2003. Mr Magill was also the CEO. This was surprising.
- 22.7 They were also reluctant to acknowledge that the submissions, on their view that there was no real threat of increased competition from the importation of carpets at the time of the IPO, were quite wrong and misleading.
- 22.8 It was one thing for Feltex to maintain a strong stand that there should be no reduction in tariffs because this would be likely to cause real problems for carpet manufacturers like Feltex, and that SIP grants would continue to be essential if tariffs were to be reduced further. However, it was untenable to maintain that there would or could be dire consequences for Feltex to the extent stated in the submissions in the event of tariffs being further reduced, when what was said was (allegedly) untrue.
- 22.9 The submissions were made by Ray Bennetts, who Mr Tolan and Mr Magill both acknowledged was highly regarded. He had over 40 years experience

in the carpet industry. He was previously a senior Feltex executive, having the position of Group General Manager of Operations.

22.10 The first time that it is recorded that the matter of the Productivity Commission's inquiry came before the Board was at its meeting on 21 January 2003. The Group Operating Report for December presented to that meeting proposed that the CDSP (Corporate Development & Strategic Planning) section of Feltex would assist Mr Bennetts with a Feltex submission "*Outlining our concerns, particularly in relation to our vulnerability to synthetic carpet imports in a low tariff environment*".⁴⁰⁹ The executives who were involved in the CDSP were David Mayfield and Julie Simons, together with John Kokic. The Project Review Update presented by Mr Bennetts to this meeting⁴¹⁰ backgrounded the proposed inquiry by the Productivity Commission. This referred to the particular threat to the TCF (Textiles, Clothing & Footwear) sector from the speculated free trade agenda between Australia and USA and that this could have a potential adverse impact on the Australian carpet manufacturers, especially man-made fibre which "*could see a contraction in investment and employment in Australia by Feltex*". Mr Bennetts said that it was his view that "*In the interests of Feltex shareholders investment in Australia, and in particular, the man-made fibre (synthetic) stream, that it is represented at the upcoming hearing and that it supports the CIA (Carpet Institute of Australia) position on behalf of the industry*". He said that while tariff protection was not necessarily the only issue in the long term viability of the industry, it was an important part of the mix.

22.11 The same project review update was again presented to the Board meeting held on February 2003.⁴¹¹

22.12 The Feltex submissions dated March 2003⁴¹² were referred to fully several times during the trial in the cross-examination of defendant witnesses. The Executive Summary⁴¹³ states:

FA believes that MMF sector of the carpet industry will face the greatest threat from the tariff reduction schedule for 2005 and will be

⁴⁰⁹ BP2 001494

⁴¹⁰ BP2 001522

⁴¹¹ BP2001635

⁴¹² CB4 003295

⁴¹³ CB4 003296

further adversely impacted by any additional tariff reduction after 2005. FA believes that carpet import volumes are sensitive to tariff change.

FA has the view that any increase in competition from imports of MMF carpets post 2005 will threaten the underlying economic viability of the Company, and could result in downsizing, plant closure, job losses and a decline in investor confidence for key stakeholders.

FA believes that much needs to be done by employers and labour force elements (including unions) to embrace more flexible work practices in the pursuit of an international competitive position.

- 22.13 The submissions made it clear that Feltex was lodging its own submission, in addition to the submission made by the CIA:

... to highlight the issues which it believes have particular relevance to the future of Feltex Australia as a key player in the Australian carpet industry.

- 22.14 Feltex further submitted that:

Carpet import volumes are sensitive to movements in import tariff levels. Import volumes are less sensitive to exchange rate fluctuations.

- 22.15 Feltex provided data to support the correlation between import tariffs on carpets and the level of carpet imports entering Australia, including by reference to a graph at Appendix 1.⁴¹⁴ It said that in the 12 year period from 1991 import tariffs had reduced from 35% to the current 15% and that:

During that time the level of imports has been increased by almost double in both volume and market share terms.

And:

While exchange rates may have had some impact, over the past 2 years when A\$ / US\$ rates had been in historic lows, import volumes have not declined, and have maintained the increased share of total market that has occurred over the last 12 years.⁴¹⁵

- 22.16 Feltex emphasised that its operations had a significant bias towards the MMF sector of the market, which it predicted would be the main target for

⁴¹⁴ CB4 003303

⁴¹⁵ CB4 003298 – this was also the view espoused in FNZC's research report which was circulated to Feltex management before it was finalised in early May 2004 - CB 14 010926 & CB 14 010927@010930

increased import competition.⁴¹⁶ It said that approximately 80% of its total output was MMF carpet.⁴¹⁷

22.17 Feltex's submission again said:

Increased competition from imports will lead to the forced downsizing of FA operations, with the likely impact being under utilised assets, higher costs, reduced employment, financial pressures for key stakeholders, or further rationalisation of the remaining MMF producers.

22.18 In support of its submission for the continuation of the SIP program, Feltex said:

The Australian carpet market is very cyclical and relatively small by world standards; consumer expectation is similar to that in other developed economies (eg USA, EEC), but is spread across both wool and MMF products. This is a demand pattern unique to Australia.⁴¹⁸

22.19 In respect of labour relations, Feltex submitted:

Employers and the various components of the labour force (employees and unions) must understand that in a low tariff environment the workforce must be prepared to accept change. The opportunity to prosper behind a tariff barrier is gone and there will be no industry, and hence no jobs, unless all players accept the need for change and a move to an internationally competitive position. Stronger industrial relations legislative measures are needed to provide a more stable business environment.⁴¹⁹

22.20 The CIA submission to the Productivity Commission in March 2003 included that imports had risen from 11 percent of the market in 1991 to 20 percent of the market in 2002.⁴²⁰

22.21 The CIA further submitted that:

If the import growth to date is extrapolated through to 2005, the consequential displacement of local production would be significant.⁴²¹

22.22 Mr Bennetts' Project Review Update dated 11 April 2003 was provided to the Board meeting held on 29 April 2003.⁴²² This recorded that Feltex had

416 CB4 003298
 417 CB4 003304
 418 CB4 003300
 419 CB4 003302
 420 CB4 003246
 421 CB4 003254
 422 BP2001809

completed and lodged its submission and that the major element was to support the CIA to maintain tariff at 2005 levels, continue SIP funding at current levels and seeking a stronger IR climate to deliver workplace labour reforms. The update concluded:

The Feltex submission also emphasised the risk it faced from any tariff reductions due to its particular bias towards man-made fibre carpet production in its Australian mills.

22.23 Mr Feeney said in chief that he wanted to amend his brief because he had recalled that he had in fact seen the “*now famous or infamous presentation*” to the Productivity Commission. He believed that this was because of his relationship with Carpet Call.⁴²³

22.24 A further Project Review Update was presented by Mr Bennetts to the 27 & 28 May 2003 Board meeting, by which time the Productivity Commission had released its interim report. He outlined what the Productivity Commission’s position in the interim report as to reduction in tariffs and continuation of the SIP program and said that public hearings were scheduled for parties to respond, concluding:

The Carpet Industry of Australia will be responding on behalf of the industry in general.

*Feltex will respond on its own behalf, but will focus on issues that are of primary relevance to Feltex, ie the threat to the synthetic elements of Feltex’s business in Australia.*⁴²⁴

22.25 Those submissions were made in person to the Productivity Commission on 4 June 2003⁴²⁵ by Mr Bennetts and, notably, also present was Mr Kokic (Mr Magill agreed that the reference in the transcript of the submission to a “*John Kirk*” would have been to John Kokic). So Mr Kokic was obviously aware of what Mr Bennetts was submitting at this hearing when Mr Bennetts essentially repeated what had been said on behalf of Feltex in its March written submissions.

22.26 Mr Bennetts said in the June submissions that the increase in the volume that market share delivered to imported product was in the order of 6,000,000 metres in the 10 year period from 1991, which, to put that in

⁴²³ NOE 2494/5-16
⁴²⁴ BP3 001932 @ 002027
⁴²⁵ CB6 004251 @ 004346

perspective, was a very substantial part of Feltex's current overall business and exceeded the volume of any other manufacturer other than the major two in the carpet industry.⁴²⁶

22.27 Mr Bennetts repeated that there was a clear relationship between the growth in carpet imports and the reduction of tariff rates. He further repeated that it was interesting to note that during the 10 period the exchange rate had fluctuated from in excess of 70 down to the low 50s at one stage but that during that time there was no correlation that could be drawn between exchange rates and the change of imports. He said:

It was more a function of what was happening with tariff rates and we deduced from that that the volatility of the exchange rate movement has probably discouraged importers from getting too involved just in the exchange rate-driven mechanism.⁴²⁷

22.28 Mr Bennetts further said on behalf of Feltex:

The sector that's at major risk is the man-made fibre section of which Feltex has a particularly exposed position. We further submit that the increases in imports, while submitting they'll come mainly out of the man-made fibre section of the market, will almost most likely be at the premium end of the market. In other words, at the higher value products generally with higher profit margins. This is because at the lower end of the market the freight and distribution costs make it less attractive for importers to bring in cheap product... Under the scenario we submit that Feltex is at significant risk with the ultimate probability that some downsizing and/or exiting of some or all of the market sectors is a distinct possibility.⁴²⁸

22.29 The submissions further continued to support the continuation of a SIP type assistance program for a period of 10 years (as against an 8 year period proposed by the Productivity Commission) and funded at current levels (rather than being reduced).⁴²⁹

22.30 It is to be noted that while the directors, apart from Mr Feeney, apparently had no recollection of seeing the March 2003 submissions made on behalf of Feltex to the Productivity Commission, several of them said that they would have read the further submissions in May 2003,⁴³⁰ which did not refer to the dire consequences for Feltex in the same way as had been referred to in the

426 CB6 004346
 427 CB6 004347
 428 CB6 004348
 429 CB6 004348
 430 BP3 002195

March 2003 submissions. The March submissions were in large part repeated again in the June 2003 submissions.⁴³¹

22.31 The Board minutes for its meeting held on 29 July 2003 recorded (item 5.11) that Feltex had made a submission to the Productivity Commission.⁴³²

22.32 There had by then also been an exchange of emails dated 27 June – 2 July 2003 emanating from the CIA and Mr Magill to the Feltex directors about a proposal for an Australia - Thailand Free Trade Agreement, in which Mr Magill said that:

*Our share of the Australian market will also be at risk as will our strategy to build our share of the Australian woven market.*⁴³³

22.33 In response to this dated 2 July 2003 Mr Saunders said:

*Clearly we will become increasingly vulnerable to Asian – especially Thai – competition in a reasonable short space of time. Now is the time to get to grips with options to base plans going forward.*⁴³⁴

22.35 In cross-examination Mr Saunders said that he could not remember sending his email of 2 July 2003 but he said he didn't think there was much doubt that he did send it.⁴³⁵

22.36 The Group Operating Report for August 2003 supplied to the Board for its meeting on 30 September 2003 referred to the CIA having met with chief Australian negotiators for both the USA and Thailand Free Trade Agreements:

Industry concerns have been highlighted to the negotiators. Industry delegations have met with Government Ministers and further reinforced the concerns the industry has. Unfortunately, indications are strong that the Australian Government wishes to proceed with FTAs as quickly as possible.

22.37 It is to be noted that there is nothing in any of the papers that the Board received on the issue of the submissions to the Productivity Commission or, in particular, in Mr Bennetts' Project Review Updates to suggest that the

⁴³¹ As to the evidence that directors would have read the submission made in May 2003 is Messrs Thomas BOE at [181], Magill BOE at [200], Saunders BOE [164] & [166]; Feeney BOE at 2494 line 5 to line 1; Stearne BOE at [142], Hamilton BOE at [52(c)] also referred to this.

⁴³² BP3 002452 @ 002458

⁴³³ CB6 004396 - 004398

⁴³⁴ CB6 004637

⁴³⁵ NOE 2061/19-24; NOE 2063/11-5

submissions being made by Feltex were in some way simply “*gaming behaviour*” or “*an exaggeration*” which might be expected for an industry lobby. Consistent with this, when the issue of the Thai and USA Free Trade Agreements came up a short time later there were obviously concerns on the part of Mr Magill and Mr Saunders about this and also on the part of the CIA.

- 22.38 It is very surprising, to say the least, that nothing in regard to the concerns and consequences expressed to the Board in relation to the Productivity Commission inquiry or the proposed free trade agreements or the content of the submissions made by Feltex was raised with the Due Diligence Committee. They are not referred to in any of the management interviews or elsewhere. In his interview by the Committee Mr Kokic referred to the issue of the risk from tariffs reducing⁴³⁶ but nothing was said by him about the submissions to the Productivity Commission or to explain the basis on which they had been made or why the dire consequences submitted on behalf of Feltex (which Mr Kokic heard for himself) were now of no real concern (if that indeed was the case).
- 22.39 In his interview on 2 April 2004⁴³⁷ Mr Kokic said, in what is recorded as quite a short statement as to “*Risks to the business*”, that imports may be a risk to the business if the currency moved to 85 cents (ie A\$ / US\$ cross rate). He said that shipping was no longer an inhibitor but considered that distribution channels were. He also referred to the Shaw agreement because it enabled the company “*to protect itself from imports*”. He also said the company would need to keep an eye on China.⁴³⁸
- 22.40 It is also to be noted that neither Mr Bennetts or Mr Kokic gave evidence for the defendants in order to provide any further explanation as to the basis of the Productivity Commission submissions. As stated, the directors could not recall any specific knowledge of them, except Mr Feeney. When the submissions were put to them they sought to downplay them as being what would be expected for an “*industry lobby*” or as being “*an exaggeration*”, although they were not willing to accept that the submissions on behalf of Feltex could be described as “*misleading*”. The implication also has to be that Mr Bennetts and Mr Kokic were personally prepared to be parties to

436 DD1 000213 @ 000217
 437 DD1 000213
 438 DD1 000217

what was effectively a charade by Feltex, if the directors' views as to the submissions is to be accepted.

22.41 In his BOE Mr Magill said, in relation to his Due Diligence Committee interview on 6 April 2004, that:⁴³⁹

I discussed imports, including the agreements we had with Shaw USA. I said that I thought imports would increase over time as tariffs fall, but that I did not think imports would swamp the market. I explained my view that currency exchange rates would be the biggest factor influencing levels of imports.

22.42 In the Legal Due Diligence report dated 27 April 2004,⁴⁴⁰ in relation to tariff reform and free trade agreements, it was stated:

Additional competition could enter the Australian market as a result of the Australia / USA free trade agreement recently finalised which requires a harmonisation of tariffs. In addition, an Australia / Thai free trade agreement has also been concluded which is expected to come into force in January 2005.

22.43 So it was known in the lead up to the IPO that imports of carpet would or could very well increase. In cross-examination Mr Gilbertson did not see that this statement in the Legal Due Diligence report was inconsistent with what was stated in the prospectus because the report said that the gradual reduction in tariffs "will in time" expose the Australasian base carpet manufacturers to greater competition from imports⁴⁴¹ and that Bell Gully were not experts in carpet.⁴⁴² He also said that ultimately all statements in the prospectus were the responsibility of those with liability, in this case the directors of Feltex.⁴⁴³

22.44 The Board must be taken to have decided that the risk in relation to increased carpet imports was sufficiently described in the prospectus. What had been said to the Productivity Commission and the risk created by the Thai – Australia Free Trade Agreement were presumably either overlooked or, in the case of the latter, it was decided that this did not need to be stated. Either the Board must be taken to have decided that investors did not need to have this information disclosed to them in order to enable them to make

439 BOE para 151(c)
 440 DD 2 000575 @000766
 441 NOE 2542/6-10
 442 NOE 2542/11-12
 443 NOE 2542/27-28

an informed decision whether or not to invest or it was careless in not doing so.

22.45 Submitted it is very likely that investors would have regarded that information as being material. However, non-disclosure was consistent with the prospectus containing no negative information about Feltex, except by reference to some issues in past years that affected its performance⁴⁴⁴ and as stated in the risks section, although the latter was not negative information about Feltex as such but related to external factors that could be risks to Feltex's business in the future.

22.46 It is also to be noted that nothing was said in the Feltex submissions to the Productivity Commission as to what was referred to by Mr Magill in evidence that the effect of carpet imports depended on the type of carpet being imported, because rugs and related products were not the market that Feltex was in. Nor what Mr Magill said that a substantial part of the carpet imports into Australia came from New Zealand, which did not compete with Feltex because they were manufactured by it there.

22.47 Nor were any of the mitigating factors referred to in the prospectus in relation to the risk of imports, at p127, referred to in Feltex's submissions to the Productivity Commission. A potential investor would be expected to have been concerned to know why this was the case, relative to the submissions that had been made by Feltex about the consequences of further tariff reductions.

23. Extended Credit Sales/Forward Dating – 4ASOC para 63 and 64

The Financial Reporting Systems

23.1 Feltex operated two different financial reporting programs. Feltex Australia operated the Global System Manager (GSM) system. Feltex New Zealand used the SAP system.⁴⁴⁵ The two systems were not integrated.⁴⁴⁶

23.2 On or about 3 May 2003, Feltex introduced the GSM system into New Zealand for sales transactions.⁴⁴⁷ Forward dating of invoices was a Shaw

⁴⁴⁴ Prospectus pp 81-83

⁴⁴⁵ DD1 000213

⁴⁴⁶ CB14 010927 @ 010968

⁴⁴⁷ Tolan NOE page 1567 line 24 to 1568 line 25 BP3 001932 @BP002013

Australia practice which was introduced into Feltex New Zealand at this time. SAP continued to operate in New Zealand for manufacturing accounting and financial reporting. In Australia the financials were held in GSM.

23.3 Mr. Tolan explained that the consolidation of results was run through Excel spreadsheets from data exported from both the SAP and GSM systems.

A. *...So we had two separate accounting systems with two separate statutory organisations. Feltex Carpet Limited operated SAP, Feltex Australia, the Australian operations used GSM. We then consolidate the results through spreadsheets.*

Q So that was downloaded into Excel or something of that sort, was it, from the GSM system?

A. *Well both from SAP we took the trial balances out of SAP, we took the trial balances out of GSM. We put them in an Excel spreadsheet and mapped them to the right summary financial reports.*

This manual intervention by the Finance team to create the consolidated financial results explains the lack of a integrated general ledger within the GSM data retrieved from Godfrey Hirst as experienced by Mr. Harper, Professor Newberry and Mr. Farley when considering the GSM data.

Invoicing Practices within the GSM system

23.4 As a result of the limitations of the GSM system, Feltex did not have a way of altering the customers terms and conditions of sale to reflect agreed credit terms for particular orders. Consequently, Feltex developed the practice of forward dating of invoices. That this was a known issue within Feltex management and at board level is reflected in many of the Feltex documents that were referred to various witnesses. Mr Tolan advises that the practice had board approval in his brief of evidence at paragraph 118.

23.5 When being led by Mr Cooper Mr. Tolan was referred to the minutes of the Audit and Risk Management Committee ARMC dated 23 June 2004 448 which discussed forward dating of invoices:

Q And the second of those bullet points records that you advised that the matter was being addressed as part of the IT business process maps. Could you explain please what that

means?

A *At that stage we were looking at acquiring a new accounting system for Feltex and as part of those IT business system maps, we wanted the functionality in the computer system that instead of forward dating invoice, we would have the functionality to change the credit terms of a particular invoice. So the invoice would carry the date the carpet was dispatched but we could actually go in and flag that invoice that had different payment terms, 60 days as opposed to 30 days.*

Q And was that matter subsequently addressed in that way?

A *No it wasn't because we never got round to implementing a new accounting system at Feltex.*⁴⁴⁹

23.6 The forward dating practice was utilised to record changes in credit terms both for customers ordering in the last 10 days of the month and extended credit sales. It could also have been used for "bill and hold" transactions.⁴⁵⁰ The forward dated invoice was entered on the statement in the month of dispatch, but was not due for payment in that month.

23.6 In the same ARMC minutes of 24 June 2004⁴⁵¹

"Mr Horrocks noted that there had been an extension in credit terms which resulted in higher receivable balances at the end of June 2004 and that this was probably material enough to warrant some additional audit procedures on the major debtors."

In the same passage of evidence Mr Cooper asked Mr. Tolan about this comment and then noted

Q ... And then the following bullet point records that you noted that the extended credit, sorry the extended terms related to programmes such as the Stainmaster programme and initiatives, they were designed to secure a higher proportion of customer business. Can you just explain what that refers to?

A. *Well first of all the reference to Mr Horrocks there. The audit committee was always conscious of us complying fully with the accounting standards, of revenue recognition and at all audit committees and reporting periods, they did request the auditors to have a close look to make sure we were complying with the revenue recommended procedures so that that bullet point refers to that request. The next point there was an initiative where we were relaunching the Stainmaster*

449 Tolan NOE page 1533 line 5 -17 – this evidence contradicts the statement at para 119 the invoices for sales under roll promotions were not forward-dated. See also CB19 013845 which clearly establishes extended credit for roll promotions were invoiced using the forward dated function

450 Tolan brief para 109 to 128 CB1 000546, CB19 013845

451 CB17 012185 @ 012186

programme and customers were 144evitalizati by that carpet on that programme and they were given extended terms; in a way similar to the roll programmes but this was just a specific launch of a new product range or 144evitalization of a product range.

23.7 Feltex's credit controller Mr. Jackson confirmed that the concept of forward dating impacts on the company's business in two areas:

1. Normal month end.
2. Extended term programs such as the Summer Roll program.

But advises that it should not be used for bill and hold⁴⁵²

23.8 In summary the invoicing practice within the GSM system described generically as "forward dating" was utilised to record credit sales where the carpet was dispatched whether for extended term programs or normal month end, but should not have been utilized for bill and hold as the carpet remained in the warehouse. The revenue was recognized at the date of dispatch rather than the date of the invoice. In the case of the bill and hold transactions, the revenue should only have been recognized when the customer expressly accepted the billing created by the invoice and confirmed the settlement terms. Whether the latter occurred on every occasion is unclear.

Ernst & Young's Response

23.9 The practice of forward dating remained under scrutiny by the ARMC and Ernst & Young until the practice ceased in about about October 2005 during FY2006. Mr. Tolan's explanation at paragraph 126 of his brief was:

"Feltex was however advised by Ernst & Young that the practice of forward-dating invoices should not be continued under the new International Financial Reporting Standards (IFRS), and so the practice did not continue in the following (2006) financial year once Feltex started reporting under IFRS"

23.10 However the June 2005 Ernst & Young June 2005 draft report to the Audit and Risk Committee⁴⁵³ recorded that the forward dated sales as at 30 June 2005 was \$11.8 million or 29.2% of debtors. It also recommended that the removal of the forward dating practice. The practice ceased soon thereafter.

452 CB20 014222 and Newberry brief para 85
453 CB13 008248 @ 013865

NZD						
Total	Future	1-30 days	31-60 days	61-90 days	90+ days	
\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000
15,450	2,215	10,779	1,645	657	153	
	14.3%	69.8%	10.6%	4.3%	1.0%	

Commentary

Forward Dated Invoices:

Of the Australian debtors balance as at 30 June 2005 of \$40.3m, \$11.8m (29.2%) relates to "forward-dated" invoices; while in New Zealand "forward-dated" invoices amount to \$2.2m (14.3%) of the total debtors balance of \$15.5m. The practice of forward dating invoices arises as a result of the following:

- Sales made to interstate customers who request for the goods to be delivered at a future point in time. To ensure that the goods are received by the customer at that requested point in time, an agreement is reached that the goods will be delivered earlier than the required date, but payment will not be due until a later point in time; or
- Promotion programs (i.e. summer roll, autumn roll, winter roll and spring roll) are offered throughout the year whereby customers are granted extended credit terms.

The practice of "forward-dating" invoices is a business decision and is effectively extended credit terms. It is done so as not to alter a particular customers' actual agreed upon credit terms. "Forward-dated" sales are on a "no return" basis however we note that there is no formal documentation in place for these sales. Feltex's history of bad debts (refer below) is low and accordingly we are comfortable that history demonstrates these accounts to be recoverable. We recommend that the practice of "forward-dating" invoices be reviewed in order to establish whether there is a way to alter customers' credit terms in the system and accordingly remove the need for this practice.

Extensive substantive audit procedures (eg debtors circularisation and proof of delivery) were undertaken to ensure the existence, accuracy and appropriate recognition of these accounts. We do not consider there to be any residual audit risk in relation to forward dated invoices.

Provisioning:

The primary reason for the decrease in the provision for doubtful debts as a % of trade receivables is due to the general provision in Australia and New Zealand being reduced from 2% to 1% of trade receivables. In Australia, \$2.8m (7%) of the total debtors balance is aged greater than 90 days, \$1.9m (62%) of which relates to 5 customers. In New Zealand, \$253k (1%) of the total debtors balance is aged greater than 90 days, \$226k (89%) relates to 5 customers.

Rebates and Forward Dating

23.11 Mr Cameron gave evidence⁴⁵⁴ of the combination of credit and rebates for the growth strategy. Feltex granted credit (which was achieved by forward dating of invoices) to encourage sales and enable some retailers to achieve their rebate targets at the end of the quarters.

23.12 Mr Tolan's presentation to the Due Diligence Committee and the Board on 8 April 2004 455 describes the strategies to achieve the increase in sales for the forecast and projection. These included:

Increase rebates to generate growth in sales

To reinforce the growth strategy, and to encourage the movement of business from our competitors, we will offer extended terms for this sales growth

23.13 As the only way in which the GSM system could record these extended terms, it is tolerably clear that the change in strategy to offer extended terms

⁴⁵⁴ Cameron NOE 2403-2405

⁴⁵⁵ CB11 007831 @ 007842

in combination with the increased rebates would result in an increased forward dated sales at the end of FY 2004 and if the strategy is successful in growing market share an ever greater percentage of forward dated sales at the end of FY 2005.

23.14 That this growth in extended credit sales occurred was noted by Mr. Horrocks in the Audit and Risk Management Committee minutes on 24 June 2004456. He considered it significant enough to seek “*additional audit procedures on the major debtors*”.

23.15 Under cross-examination about the growth of extended credit sales in FY2004 Mr. Horrocks confirmed that the practice increased during this period.

Q. And Professor Newberry’s evidence was that practice increased in, in that year 2005 but it increased substantially in June 2003 – June 2004 – do you recall that evidence?

A. *I recall Professor Newberry making that point, whether I would agree with that I – at the end of the day we did and there is ample, um, evidence within the reporting of the company, we did have a programme that was running through this period which resulted in extended credit terms being offered and rebates. It did not in any way concern me as to materiality because the key issue that I was concerned with was working capital and the, these were tools that were, the company used just as its competitors used.*

Q. But there are two issues aren’t there, there’s the question of working capital and there’s the question of revenue and posting sales and I’m suggesting to you that by using extended credit terms to boost your sales, that is something that should have been disclosed in the Prospectus?

A. *And my reply is that, um, I would expect management to use the tools that were available to it to provide the sales results that they did, so that deals with the revenue point. The other point which is the more serious point is if working capital got*

*out of alignment, which it did not.*⁴⁵⁷

23.16 Mr. Horrocks was also cross-examined as to the extent of credit sales in debtors at year end 2004.⁴⁵⁸ He acknowledged that there was no formal report such as the report generated by Ernst & Young for FY2005. After an examination of the Group Operating Reports ⁴⁵⁹ he was asked:

- Q. So I'm suggesting to you that if you take the 23 million for Australian Group and for Australian June sales from the Australian not due June figure, you've got an implied extended credit figure of 10,291.
- A. *It could be. I, I would have to – this is a debtors report. I'd have to go back and refresh myself as to how those sales report linked in to the debtors report, but it could be in round terms.*

Set out below are the extracts from the June 2004 Group Operating Reports used to derive the implied extended credit amount in debtors as at year end FY2004 put in cross-examination to Mr. Horrocks.

Group Operating Report - June 2004	June 2004 CB Reference
Australian Residential sales	A\$14,778,000 BP5 004012 @ 004057
Australian Commercial sales	A\$8,754,000 BP5 004012 @ 004061
Total	A\$23,532,000
Australia debtors – not due	A\$33,923,000 BP5 004012 @ 4079
Australia June sales	A\$23,532,000
Implied extended credit in debtors FY2004	A\$10,291,000

23.17 In the absence of a specific report such as the analysis undertaken by Ernst & Young for FY 2005, and in the face of a clear contemporaneous statement by Mr Horrocks in the ARMC minutes that *“an extension in credit terms which resulted in higher receivable balances at the end of June 2004”* the only inference that can be drawn from the printed documentary material before the Court is that the increase in credit sales in debtors was likely to be in the order of A\$10 million.

457 Horrocks NOE page 2332 at line 6 to line 25
 458 Horrocks NOE page 2321 to 2329
 459 BP5 00412 @ 004030 June 2004 Group Operating Report

Professor Newberry's Analysis of the GSM Data

- 23.18 Much has been said about the reliability of the GSM data and the fact that the data cannot be reconciled exactly to the company's management accounts or financial statements. Such criticism is unfounded. The analysis undertaken by Professor Newberry is acknowledged to be from incomplete records.
- 23.19 Mr. Tolan asserts that as the data cannot be reconciled to the general ledger it is unreliable. No such general ledger has been discovered by the defendants. The GSM data retrieved from Godfrey Hirst does not include a general ledger as noted in 24.3 above. There is simply no general ledger to reconcile the sales data to. Mr. Tolan when cross-examined about differences between Exhibit BB which he produced from Group Operating Reports was unable to adequately explain the differences with the company's financial statements⁴⁶⁰, that is the problem of working with incomplete records. The inability to correlate exactly does not call into question the reliability of the data in the Group Operating Reports, or indeed in the GSM data.
- 23.20 There can be no doubt that the GSM data is in fact Feltex's data. The plaintiff has established the chain of custody through Mr Davies. Mr Harper gave evidence that the CCIS data was complete. The invoice sequences in the CCIS database were intact. The spreadsheets created by Mr Harper have been reconciled by Mr Farley. Mr Harper has confirmed that the spreadsheets in the common bundle are his spreadsheets even though some have been sorted and some have had totals added. Although the spreadsheets embedded properties show they have been saved by "AJ Gavigan", it is tolerably clear that the person who did this was junior counsel Mr TJP Gavigan. The underlying integrity of the data and the Harper spreadsheets has not seriously been challenged. Mr Harper confirmed his evaluation at the spreadsheets:⁴⁶¹

For documents CB1 00008 through CB1 00013 they were exactly as I had submitted. For document CB1 00014 it exhibited the same behaviour, it had been sorted and had totals inserted. For document CB1 00015 it had been sorted, had totals and there was also an additional row total at line 4497. That row did not impact on the totals

460 Tolan NOE page 1549 line 1 to page 1559 line 10
461 Harper NOE 210 line 11 to line 24

for the file. For file CB1 000016 it had been sorted, had totals, there was an additional blank row at the, sorry an additional row at the top and a blank row at row 5472. The totals for that file did not differ to mine or to those provided by Richard Farley. For file CB1 000017 it had been sorted and had totals added. File CB1 000018 was identical. File number CB1 000019 had been sorted and had totals. The overall totals for the file everything agreed. And for files CB1000020 through CB1 000034 there had been no change. They were as I had provided. That's all on my list Your Honour.

23.21 Professor Newberry explained her view of the reliability of the data in the CCIS data base:462

"I, I can't say this is exactly it and I never will be able to say it. The material I have is, is the invoices from the sales system and as I've explained there are other parts in a multi-modular system, such as what Feltex would have been running, there's other matters that affect what's going to be recorded as sales and I have no way of identifying those, I have no access to the general ledger system to be able to confirm or otherwise. And, and I don't think it's possible now to, to tie it down to a detailed reconciliation. We're working with what we can only call "incomplete records". I've had to infer what the system is for close-offs from the data, the sales data so other, so other than the sales data in Mr Tolan's explanations, that's how I've inferred how that sales process works within Feltex Australia. Having said that and I recognise that the data is incomplete, having said that, when I look at those graphs, when I look at the percentages reported for Australian sales as, as, you know a percentage of Feltex's sales, that's obviously going to change from month to month but it's an approximate. And when I look at the fact that to get those figures I'm including in those months' sales all of the forward-dated invoices that have been recorded for that month, so, so if it's June sales any invoices that are dated July or after July are included in June sales. So to track like that it requires the inclusions of the forward-dated invoices and those invoices are in the sales, in the invoicing system, in the CCIS system showing as that period because each of those files that Andrew Harper produced relates to an accounting period. To me I, I can't say what level of evidence you want but to me it looks more likely than not that, that this is valid."

23.22 Professor Newberry explained the analysis she undertook with the data as follows:463

As Mr Harper said yesterday, to those files, is around 20,000 lines and so to be able to analysis it in the way I have, I needed to be able to sort it and you can sort it and still keep the lines in line but you're getting it in, the lines presented in a different order and I think that was what the questions were about, Mr Harper's data. So the sort that I conducted was first of all there's a hierarchal sort arrangement, first of all by transaction type, in other words is it an invoice or is it a credit note because I'd missed that the first time. Secondly, by

462 Newberry NOE Page 223 line 18 to page 224 line 9
463 Newberry NOE Page 349 line 29 to 350 line 30

transaction date and we've got this question of forward-dating which is why I've used transaction date and thirdly, by the date entered. And so transaction type is at column H, I can't – I can't recall what I was looking for then was, was doing subtotals of amounts in column AA which is the sales net of GST and so that's how I've calculated those figures shown for forward-dated invoices. What, as I've also explained in my brief and here, that Feltex operated a sort of practical cut off process and I have no issue with that, but it meant that in some months the transaction processing and I'll use March 2004 because that, some of those invoices were put in front of me yesterday. It means that in some months the processing will run on into the next month, into April and I've explained in my brief, I've identified what the cut off date is and then where transactions are entered and dated on one of those run on days, so the 1st of April, then I've included those as being March transactions, I haven't counted them as forward-dated and the transactions that were put in front of me yesterday, which you know is quite hard cold, were entered and dated on the 1st of April 2004. And in fact the cut off date for March for Feltex in 2004 was the 4th of April 2004 so those transactions that were Feltex transactions, which I agreed were Feltex transactions, were actually included in the March processing. Last night I went back and had a look through those files just to see again whether there were any Feltex transactions in the items listed as forward-dated and there were not. If I can get my notes, I did find some, in particular months and I will disclose those but they make no difference to percentages or anything like that but March and May which are important months for this prospectus, and June 2004, there are no Feltex transactions and no intercompany transactions in the forward dated invoices.

- 23.23 In all the circumstances there can be no serious doubt that the data is Feltex data and that it can be relied upon.

Summary of Professor Newberry's Analysis of the Forward Dated Invoices

- 23.24 At paragraph 11 of her reply brief dated 24 March 2004 Professor Newberry sets out in table form her analysis of the changes in forward sales.

Table A

Period	Forward sales re future accounting period	Change in forward sales	Period sales	% of period sales
FY03	\$2,483,390			
1H04	\$2,960,638	+\$477,248	\$125,715,219	0.0%
2H04	\$8,805,078	+\$5,844,440	\$111,388,912	+5.2%
FY04	\$8,805,078	+\$6,321,688	\$237,104,131	+2.6%

1H05	\$10,162,080	+\$1,357,002	\$120,177,667	+1.1%
2H05	\$10,856,588	+\$694,508	\$100,233,477	+0.7%
FY05	\$10,856,588	+\$2,051,510	\$220,411,144	+0.9%
1H06	\$370,266	-\$10,486,322	\$102,953,577	-10.2%

23.25. For 30 June 2003 the sales included (period 12) but dated into the new financial year (ie July 2003) were:

Sales included in April 2003 and dated July 2003:	\$2,310
Sales included in June 2003 and dated July 2003:	\$2,481,080
Total forward dated sales 30 June 2003:	\$2,483,390

23.26 For 31 December 2003 the sales included (period 6) but dated into the next half year (ie June 2004) into December were:

Sales included in October 2003 & dated January 2004:	\$15,018
Sales included in November 2003 & dated January 2004	\$14,627
Sales entered in December 2003 & dated January 2004:	\$2,930,993
Total forward dated sales 31 Dec 2003	\$2,960,638

23.27 For 30 June 2004 the sales included (period 12) but dated into the next financial year (ie July 2004):

Sales included in June 2004:	\$8,805,078
Total forward dated sales 30 June 2004	\$8,805,078

23.28 For the half year to 31 December 2004, sales included (period 6) in the half year sales but dated beyond 31 December 2004 were:

Sales included in October 2004 & dated January 2005:	\$2,690,765
--	-------------

Sales included in November 2004 & dated January 2005	\$2,670,531
--	-------------

Sales included in December 2004 & dated forward ⁴⁶⁴ :	\$4,800,703
--	-------------

Total forward dated sales at 31 December 2004	\$10,162,080
--	---------------------

23.29 For the half year and whole financial year to 30 June 2005 the sales included (period 12) in the half year sales but dated into the new financial year (ie July 2005 or further ahead) were:

Sales included in March 2005 and dated July 2005:	\$14,832
---	----------

Sales included in April 2005 and dated August 2005:	\$74,879
---	----------

Sales included in May 2005 and dated September 2005	\$3,637,364
---	-------------

Sales included in June 2005 and forward dated: ⁴⁶⁵	\$7,129,512
---	-------------

Total forward dated sales at 30 June 2005:	\$10,856,588
---	---------------------

23.30 For the half year to 31 December 2005 (period 6), sales included in the half year sales but dated beyond 31 December 2005 (ie January 2006 or further ahead) were:

Sales reported in September 2005 & dated January 2006:	\$370,266
--	-----------

Forward dating ceased in October 2004:

Total forward dated sales at 31 December 2005:	\$370,266
---	------------------

23.31 One of the principal assumptions underlying Feltex's forecast to 30 June 2004 was that "actual results for the nine month period ended March 2004 have been incorporated into the forecast."⁴⁶⁶ The effect of the boost in forward dating is, therefore, most relevant in relation to the second half year

464 The forward dated sales in December 2004 comprised sales dated January, March, April and May 2005

465 The forward dated sales in June 2005 comprised sales dated July, September and October 2005

466 Feltex Carpets Limited, Investment Statement and Prospectus, 2004, p. 88. CB14 010675 @ 010764

(January to June 2004), and in particular, over the final three months of the financial year. As may be seen in the table above (see row for period 2H04), the increase in forward dated sales at June 2004 had the effect of boosting sales for that six month period by 5.2% (or \$5.8 million).

23.32 At March 2004 (period 9), the forward dated sales comprised:

Sales included in March 2004 and dated April	\$2,548,929
Total forward dated sales 31 Mar 2004:	\$2,548,929

23.33 At May 2004 (period 11), the sales which seemed to be considered at the final due diligence meeting, the forward dated sales comprised:

Sales included in May 2004 and dated June	\$6,413,428
Total forward dated sales May 2004:	\$6,413,428

23.34. Applying the calculation to establish the effect of this increase in forward dated sales shows that between March and May these increased by \$3,864,499, and the total sales for April and May 2004 were \$36,316,463. The increase in forward dated sales for those two months therefore amounts to a 10.6% boost in sales. A similar calculation applied over the three months of April, May and June 2004 shows that the forward dated sales boosted sales by 10.1% or \$6,256,149 to \$61,690,859.

23.35 Converting the (March - May) increase in forward dated sales to NZ\$ at the rate used in the prospectus (.8772)467 gives NZ\$4,405,494. Adding that increase in forward dated sales to the anticipated shortfall in sales makes the shortfall more like NZ\$11.9 to NZ\$13.4 million. If these adjusted amounts for an anticipated sales shortfall were considered as a percentage of the forecast sales for final three months of the year (NZ\$91,618,000) the shortfall would be between 13% and 14.6%.

23.35 In his supplementary brief of evidence Mr Tolan states the sales Professor Newberry had identified as forward dated by more than one month are sales made under the promotional "roll" programs. As discussed above the roll programs were recorded as forward dated invoices within the GSM system as a means of recording the extended credit arrangements. The distinction

that he seeks to draw between month end forward dating and roll programs cannot be supported by the available evidence. All of the forward dated invoices were for the purpose of granting extended credit to the retailer customer.

23.36 Although the data analysed by Professor Newberry cannot reconcile exactly to the Group Operating Reports, it should not be discounted. Her analysis is supported by the following extrinsic documents and evidence:

- a. the increase in the debtor's ledger between forecast and actual as at FY 2004 of \$8.961 million,⁴⁶⁸
- b. the evidence of Mr. Cameron as to the strategy of increasing sales by combining extended credit with rebates to achieve sales growth;⁴⁶⁹
- c. the 8 April 2004 presentation which sets out the growth strategy;⁴⁷⁰
- d. the analysis of the Group Operating Reports with Mr. Horrocks and his acknowledgement of the strategy and likely quantum of extended credit sales⁴⁷¹
- e. Mr. Horrocks recorded statements on 24 June 2004 ARMC that the increase in debtors was due to extended credit;⁴⁷²
- f. Mr Thomas to Mr Millard email 14 July 2004 "Bottom line is that we are there absent sales, and all very comfortable. Moreover, while I suspect some sales were accelerated into June, July is still quite strong and the order book is very strong"⁴⁷³;
- g. Mr. Millard's admission under cross-examination that he knew sales were accelerated from July into June 2004

Q And then he says, "Moreover, while I suspect some sales were accelerated into June, July is still quite strong." Isn't he saying to you that the figures for June have been boosted to achieve the level of sales that were achieved even if they were below the forecast?

468 CB13 009725 & CB17 012265 @ 012297
 469 Cameron NOE 2403-2405
 470 CB 11 07831
 471 Horrocks NOE page 2321 to 2329
 472 CB17 012185 @ 012186
 473 CB17 012532

A. *Probably, yes.*

Q. That's why he's saying, "I suspect," but nevertheless he's saying, isn't it, that the order book for July is still strong?

A. *Right, I mean June was a year end month and so it would be normal for a sales force or for customers looking for rebates to accelerate some level of sales into there. So he's saying, you know, I assume they were accelerated. July is still quite strong and the order book beyond that looks very strong.*⁴⁷⁴

h. W. McCarrison-Wilson to Mr Magill in relation to Australian sales recorded in July 2004:

*"...A good result for July considering many of the July projects were invoiced in June"*⁴⁷⁵

i. The June 2004 Distribution and Customer Service Report⁴⁷⁶ records the focus being placed on all orders that could be serviced immediately and the outstanding efforts made to achieve a positive result for the month.

j. The July 2004 Residential Sales report ⁴⁷⁷ in relation to Invicta, "We have missed budget across all brands mainly due to bringing July business into June last month. On top of this, our stock levels have depleted with a lot of capacity going towards commercial made to order." It should be noted, that this comment was omitted from the board papers for August 2004.⁴⁷⁸

Against this background, it would be wrong to dismiss Professor Newberry's analysis as unreliable when the extrinsic evidence establishes that sales for June 2004 were significantly boosted and that the growth strategy was followed.

Should the Growth Strategy Have Been Disclosed in the Prospectus?

23.37 Mr Cameron was of the opinion that sensitive commercial information which could give an advantage to Feltex's competitors should not necessarily be

⁴⁷⁴ Millard NOE 2702 line 9 to 13
⁴⁷⁵ CB17 012441
⁴⁷⁶ CB17 012536
⁴⁷⁷ CB17 012772 @ 012773
⁴⁷⁸ BP5 004152 Group Operating Report July 2004 @ 004209

been disclosed in the prospectus.⁴⁷⁹

23.38 Professor Newberry considers that the accounting standards of the day including FRS 29 required disclosure of the effect of extended credit⁴⁸⁰ In answer to questions from Mr. Cooper about disclosure and FRS 29 Professor Newberry referred him to paragraph 5.5 (b)

A 5.5B, *“Items included in operating revenue or operating expense if they are of such incidence and size or of such nature that their disclosure is necessary to explain the prospective financial performance of the entity.” So that’s required to be disclosed. “An adequate description of each item shall be given to enable its nature to be understood.” And so my argument and also that of the Securities and Exchange Commission in the United States, is that there’s this acceleration of sales, that’s making a difference to sales by increasing them over this prospective time and it’s not disclosed and so my whole argument there has been about lack of disclosure.*

23.39 Professor Newberry was unshaken in her opinion that disclosure was required, especially so when there was a complete change of shareholding through the IPO and in her opinion the technique had to stop.

A. *What I’ve explained is that this is an increase in forward-dating sales and the effect of that increase is to boost Feltex’s revenue over a short term. Eventually it has to stop, the more aggressive, if you like, means used to entice sales.*

Q. Why do you describe it as aggressive?

A. Well I said “more aggressive”

Q. Why do you describe it as more aggressive

A. *Because of the speed of takeoff and that’s where I’ve graphed that data and tried to show it in those tables. It’s significantly increased over that period.*

23.40 Professor Newberry considered that Feltex’s prospectus was misleading because of the failure to disclose these practices and in drawing that conclusion she relied on the accounting standards of the time, and specifically the requirements in those standards for adequate disclosure, and on the US Securities and Exchange Commission’s judgment in the Sunbeam case that the failure to disclose the acceleration of sales in an effort to

479 Cameron NOE 2406 line 23 to page 2407 line 4
480 Newberry brief appendix 1 para 97 and NOE page 276 line 26 to 33

achieve its sales goals, “materially distorted” that company’s financial results. Feltex’s subsequent published financial reports for the year ended 30 June 2004, and the year ended 30 June 2005, maintained the picture by giving no indication of the means used to achieve the sales reported.

24. Lean Manufacturing – 4ASOC para 60

24.1 Lean manufacturing was identified in the prospectus

As one of the reasons why Feltex was a “*responsive service-oriented manufacturer of significant scale*” – page 7

As one of “*a number of sustainable operational strategies now successfully implemented*” – page 15

As one of the reasons why Feltex had “*excellent investment features and significant potential for further earnings growth*” – page 16

24.2 What emerged through the course of Mr. Tootell’s evidence is that lean manufacturing techniques were utilized in parts of Feltex’s operations in Australia but that the work was ongoing, and were at a formative stage in New Zealand but the statements made in the prospectus overstated the position.

24.3 Despite the defendants’ criticism of Dr Blakemore it is clear that he was responsible for significant improvements in the MMF production in Australia and that Mr. Tootell learnt a lot from Dr Blakemore. Dr Blakemore was of the view that the implementation of his plans ceased after he left Feltex. What has emerged through Mr. Tootell’s evidence is that lean manufacturing changed course in Australia and was in its infancy in New Zealand at the time of the IPO.

The position in Australia

24.4 Following Dr Blakemore’s time at Feltex, the focus of lean manufacturing under Mr Tootell’s supervision in Australia shifted from production planning to shop floor opportunities. Mr. Tootell considered that the work undertaken under Dr Blakemore’s watch in reducing SKU’s and streamlining planning had reached a point of diminishing returns and changed focus of the lean programme:

“...the success that we had of the first phase of the lean programme, which was very much focused on planning systems and working in that sort of middle management, administrative functions. We achieved that, which was quite significant, which was quite an achievement but we’d, I suppose, reached the point of, yeah, really diminishing returns, I suppose, in its place and we were now moving on to the shop floor opportunities, which were the real, the main aspects of lean manufacturing really is about engaging and evolving the shop floor and getting continuous incremental improvement.”⁴⁸¹

- 24.5 Following the introduction of the GSM system into New Zealand in FY04, I. Tootell gave evidence of the introduction of the pull system into New Zealand :

“Well certainly we did the first point there in terms of continuing to implement the pull system into New Zealand, that was very much a focus during that period which we hadn’t had great success with prior to that. We did a lot of work in the organi supply chain, that second point, yes, then we did a lot of organization¹⁵⁸ on of product specs to streamline, take costs out of the, of the organi supply chain’s far more complex than the synthetic supply chain. We were able to get some very quick wins in the early days. The, yes we did recall organization on of the SKUs as I, in wool, as I mentioned earlier. The uniform measurement project, that was quite a successful initiative that continued to be implemented across that period which was really about delivering information to the shop floor and the management at the plants to be able to identify opportunities to reduce set up times and down times and so forth, so that was, that was quite a successful project that continued on. And, yeah, a lot of work around the IT systems. We were running two different ERP systems, GSM was the system in Australia and SAP was the system in New Zealand and we did a lot of work connecting those together to be able to get the pull system, the pull philosophy embedded into the New Zealand operation during that period.”⁴⁸²

- 24.6 Later in evidence he explained the timing of the introduction of the pull system into New Zealand:

- Q. And the new planning system, which is the next slide, that’s the full system that was set up under Dr Blakemore’s watch –
- A. *That’s correct.*
- Q. – in Australia isn’t it?
- A. Yes
- Q. And then later introduced to New Zealand and you’re saying finally sort of 2003, 2004?

481 Tootell NOE page 1741 lines 26-29
482 Tootell NOE 1745 line 7- 25

A. *Yeah, from memory I do recall we attempted to implement it but with a completely different ERP system. We weren't able to – an SAPs quite a large and complex ERP system with higher costs of modification so we were limited in our ability to organize at the ABC pull system so I recall we also ran, sort of, offline spreadsheet version of it for a period and then 2003, 2004 was the period when we implemented the business-wide use of the GSM system for production planning or stock replenishment, which then allowed us to implement the same reporting, same process as we had in Australia into the New Zealand business, which then organization the approach across the organization.483*

24.7 At not stage during Mr. Tootell's evidence did he suggest that lean manufacturing in New Zealand operations had advanced beyond the planning stage by the time of the IPO. Certainly it would appear it had not moved to the shop floor.

24.8 In Australia, lean planning was limited by the lack of a suitable forecasting tool for operations. The addition to the Demand Solutions module was not implemented until sometime in FY 2005.484

24.9 Further the principles of lean manufacturing were in conflict with the demands from the Sales Team for a full range of inventory to be in stock, and a solution for this tension had not been found through the planning system.

Q. Do you accept that there are complaints about lack of stock and suitable production dates?

A. *Yes. There would have been, at times. There always is with two and a half thousand SKUs, something like that. There's not always every product in stock all the time and that's meant some ranges in both wool and synthetic, were on a made to order basis, which meant that it could be up to six to eight weeks lead time to replenish that stock or to service a customer's specific order.485*

24.10 While it must be accepted that Dr Blakemore was not correct in his assessment that lean manufacturing ceased after he left Feltex, it is clear from Mr Tootell's evidence that the process of implementing lean manufacturing techniques into Feltex Australia was evolving and far from complete and was only in its infancy in New Zealand.

483 Tootell NOE page 1759 line 27 page 1760 line 10
 484 Tootell NOE 1746 line 9 to page 1747 line 33
 485 Tootell NOE page 1751 line 10 to 17

24.11 Submitted that the statements made in the prospectus overstated Feltex's position with respect of lean manufacturing.

25. Feltex was not a good investment

25.1 A number of pleadings in the 4ASOC alleged that Feltex was not a good investment (paras 34 – 37, 39, 41.1.2, 41.1.3/41.2, 42 – 46, 47-50), did not reflect fair value (paras 51, 52) and did not have proper strategies (para 72).

25.2 Feltex was sold as an investment and as representing fair value, not a speculative or high risk company. Pages 7, 90, 11, 13, 15, 16, 19, 85, 96, 91, 128 and 140 of the prospectus⁴⁸⁶ state or imply that it had substance and was a good investment. As examples, the very first substantive part of the prospectus was titled "*Key Investment Features*".⁴⁸⁷ It was shortly followed by a positive letter from the Chairman⁴⁸⁸ and then another part titled "*Investment features*."⁴⁸⁹

25.3 The overall impression given was that Feltex was a longstanding and successful company, was in good health and would get even better. Moreover, the forecast for FY04 and FY05 were both achievable and good dividend payments would be made. Feltex's business would grow, and therefore impliedly its share price.

25.4 If the factors upon which Feltex's represented itself to be a good investment and to have fair value did not exist, in whole or in part, then the corollary is that Feltex was not a good investment or less of a good investment than represented and its true value was less than represented. If that is the case, then this must affect a decision whether or not to invest.

25.5 The positive factors represented did not exist, certainly not to the extent claimed. The main ones are listed here, and this pleading is founded on all factual issues raised in this submission.

(a) sales revenue was growing only marginally in FY04;

(b) sales volume was falling in FY04;

486 All pleaded in para 51 4th ASOC

487 Prospectus p7

488 Prospectus p13

489 Prospectus pp15-16

- (c) market share had fallen in FY04 for the sixth consecutive year;
- (d) the forecast for FY04 could not be met in relation to sales;
- (e) the projection for FY05 was not reasonable;
- (f) the relationship with a major retailer, Carpet Call, was deteriorating;
- (g) there were high break even costs;
- (h) lean manufacturing had not been fully implemented;
- (i) extended credit sales / forward dating had been used to improve apparent performance;
- (j) as a result the projected dividend for FY05 could not be paid, let alone future dividends at a comparable level.
- (k) core assumptions underlying the forecast for FY04 and projection for FY05, especially as to growth, competition, imports and being able to pass on any raw material price increases were not reasonable.

25.6 Submitted the inescapable conclusion is that Feltex was less of an investment than represented and its value less that represented. The best indication of that was its performance post the IPO. It could not provide a gross yield of 9.6% unless the FY05 earnings and NPAT were achieved. Its share price reduced to nil.

25.7 Those occurred because the factors represented in the prospectus as giving value were lacking. The factors lacking included the strategies necessary to achieve the performance represented, the absence of which is supported by the fact of Feltex's pre and post-IPO performance, the restructuring in 2005, the Saunders and Thomas AGM addresses ⁴⁹⁰, the matters referred to in the New Zealand Herald articles by Rebecca Macfie ⁴⁹¹ insofar as they were confirmed by witnesses, and relevant matters given in evidence to the Securities Commission.

25.8 Mr Meredith conducts an analysis of the indicative price and valuations as a result of which he reaches the view that the indicative price range published

⁴⁹⁰ Refer to Schedules A and B

⁴⁹¹ AF1 000011

in the prospectus of \$1.70 - \$1.95 was not reasonable. 492 That analysis is also adopted.

25.9. Significant issues regarding Carpet Call and Solomons (Jim Smith) ⁴⁹³

a. Under Key Investment features the prospectus states: ⁴⁹⁴

“Feltex has continued to expand its relationships with key customers and suppliers and has significantly increased its customer service levels”

b. Under Investment features it states: ⁴⁹⁵

“Feltex has continued to expand its relationships with key customers and has significantly increased its customer service levels. As a result of these strategies, on-time deliveries and customer satisfaction levels have all demonstrably improved”

c. Under New Zealand and Australian carpet industry it states: ⁴⁹⁶

“Customers in the residential carpet market are generally carpet retailers who in turn sell carpet and other products to consumers. Carpet retailers ' recommendations can have a significant influence on the style and brand chosen by the consumer.”

d. In the ‘What are my risks section’ the prospectus makes the following disclosure in respect of Feltex’s key relationships with customers: ⁴⁹⁷

“Key relationships with customers and suppliers

Feltex's business and growth opportunities are dependent on key customer relationships (a small number of whom make up a large proportion of Feltex's revenues), and key supplier relationships ... Feltex is not aware of any impending issue

492 Meredith BOE pp85 – 94

493 Disclosure in Prospectus of customer relationships and non disclosure of a material adverse development with Carpet Call (Jim Smith) (pleadings 18.19, 42.1, 42.2.2.2, 42.2.2.3, 42.3.3, 42.3.4, 43,46.4, 48.1,48.2)

494 Prospectus, pages 7 and 41

495 Prospectus, pages 16

496 Prospectus, pages 37

497 Prospectus, page 128

that may lead to the termination of, or adverse changes to, any of these relationships.

Changes to these relationships could have a material adverse effect on Feltex's results or financial position"

Disclosure of ownership in Carpet Call

25.10 Under business description it states:

"Carpet Call

Feltex owns 50% of Carpet Call (Holdings) Pty Limited ('Carpet Call), one of the best-known carpet retailers in Australia. Carpet Call operates throughout Australia under the Carpet Call and Solomon brands. As a consequence of the sale by the Vendor of its Shares. upon closing of the Offer the owner of the remaining 50% of Carpet Call has the option to purchase Feltex's 50% interest at market value. As at the date of this Offer Document. the co-owner has not indicated whether it will exercise its option. Feltex believes that the market value of its interest in Carpet Call is greater than the carrying value of its interests in that entity. In Feltex's Financial statements. Carpet Call is accounted for as an associate. Feltex's 50% share of Carpet Call's net earnings (after dividends paid) are accounted for on an equity basis and disclosed in the statement of financial performance below the line 'Net surplus after income tax. Cash dividends received from Carpet Call are accounted for in operating revenue."

25.11 The consolidated statement of prospective financial performance⁴⁹⁸ reports that the forecast FY2004 net surplus attributable to shareholders of \$10,133,000. This figure includes \$1,400,000 (13.8%) from the retained surplus of associate companies, namely Carpet Call.

25.12 Feltex's relationship with Carpet Call was important to its financial performance through the following contributions:

- (a) Sales revenue - through the purchase of carpet by Carpet Call and Solomons; and

⁴⁹⁸ Prospectus, page 85

- (b) Operating revenue - through dividends paid by Carpet Call; and
- (c) Net Surplus Attributable to Shareholders – through Carpet Call’s net earnings after dividends paid

Deteriorating Relationship with Carpet Call (Jim Smith)

25.13 This analysis is discussed above at 19.29 to 19.38 in the context of Forecast results to June 2004. It is also discussed again here in the broader context of being a deteriorating adverse circumstance (development or change) that increases during the offer period. Mr Meredith reviewed the relationship between Jim Smith and Feltex.⁴⁹⁹ The history of Feltex’s relationship with Jim Smith extends back as far as 11 February 2001. A memo from Mr Feeney to the Board headed “Carpet Call – Some early observations of the relationship” records that:⁵⁰⁰

“At my first board meeting, Jim Smith was, according to Michael and Russell Martin, “well behaved”. Seeing as the entire one and half hour meeting consisted of Jim, Michael and Russell arguing over the history, present and future of the Shaw Carpet Call relationship, a meeting when Jim is not “well behaved” should be a sight to behold.

25.14 Mr Thomas was also concerned about the relationship with Jim Smith and raised this in an updating email to Mr Millard on 6 December 2003⁵⁰¹ where he advised:⁵⁰²

“Second, as you may recall we have a 50% interest in Carpet Call, one of the largest carpet retailers in Australia. This investment (it is actually a share interest, but we consider it more of a JV type investment) paid us our first dividend in 2003 FY of AUD 250,000. Our relationship with the other shareholder, who is the CEO, Jim Smith, is very “hot and cold.” Frankly, I think Jim is a whacko (as does the Feltex Board) with quite irrational behaviour at times. His budgeted pre tax profit this year is AUD 3 million. We have had an approach to sell our interest at about AUD 10 million. We are favourably inclined to do this--it would get us right out of retail, which

⁴⁹⁹ Meredith BOE [90] – [93], [128] – [131]

⁵⁰⁰ CB2 001768

⁵⁰¹ CB7 005737

⁵⁰² CB8 005741 at 5742. See Meredith BOE [92]

would be favourably received by the rest of the retail trade, who can be suspicious, at times, of our trading relationship with Carpet Call given our investment in the company. Cash would pay down debt. The "interest in an associate company" does not really attract any stronger potential market capitalisation in a potential IPO given the low dividend yield and our lack of absolute control over the investment."

- 25.15 A further step taken by Feltex which compounded the already difficult relationship was the decision to removed the Bank Guarantee. Des Tolan sent a letter on 14 November 2003 to the ANZ Bank ⁵⁰³ which was included in the papers for the board meeting on 1 December 2003.⁵⁰⁴
- 25.16 The decision was made to withdraw the guarantee despite a terse letter received from Barry Cook of Carpet Call on 12 November 2003 which stated their contention that Feltex was not entitled to exercise that right [withdrawal of the guarantee of Carpet Call's banking facilities] ⁵⁰⁵ . This action was endorsed by the board and recorded in the minutes of 3 November 2003.⁵⁰⁶
- 25.17 Carpet Call's reaction to the withdrawal is then recorded by Mr Magill in a Memorandum to the Directors, Mr Tolan and Mr Kokic on 30 January 2004.⁵⁰⁷ The Memorandum records that:

MEETING WITH JIM SMITH WEDNESDAY 28 JANUARY

As it was Jim's 60th birthday on Wednesday, we decided to buy him some French champagne, and start to mend the fences in our up and down relationship.

Although the relationship has a long way to go to restore a degree of reasonableness and fairness, there were some encouraging signs.

Key Points

Product Requirement

- Jim's move to smaller manufacturers although successful in product choice and sales, Carpet Call have had significant order cancellations, due to the inability of these smaller manufacturers to keep up with his delivery requirements.

503 BP4 002957 at 3070
 504 BP4 002957
 505 BP4 002957 at 3071
 506 BP4 002957 at 2964
 507 CB8 005909

BANK GUARANTEE & SHAREHOLDERS AGREEMENT

Bank Guarantee

Jim is still upset about the removal of the bank guarantee. He understands that with the current financial position of Carpet Call, the bank does not need a guarantee. However he feels the principle of its removal was wrong, based on his understanding, that Shaw promised to provide a guarantee at all times.

Notwithstanding this, he indicated that the bank had increased Carpet Call's facility without the requirement of a Feltex guarantee.

We were told on Wednesday 28 January by the bank that Carpet Call had two options,

1. The guarantee to be released with the liability to be to Feltex's account.
2. Full release of Feltex's guarantee on 1 April 2004; with no run down of guarantee liability, but an increase in Carpet Call's facility.

Carpet Call's Barry Cook phoned the bank on the morning of 29 January indicating that Carpet Call were prepared to accept a full release of the Feltex guarantee on 1 April 2004.

Des, has done a great job managing this process with Carpet Call and the bank.

Mr Meredith, upon review of the actions taken by Feltex above concluded at para 131 of his brief that

it was reasonable to infer that the relationship between Feltex and Carpet Call would have been affected by Feltex's withdrawal of the guarantee of Carpet Call's overdraft facility.

25.18 Rod Lyons, General Manager Residential Sales, in his management interview of 2 April 2004 advised the DDC that Feltex had an "interesting" relationship with Carpet Call. Mr Lyons then provides the following information: ⁵⁰⁸

- (a) Carpet Call has annual revenue of A\$19million, which is 11% of Residential sales ⁵⁰⁹;
- (b) Feltex sales to Carpet Call represent represent 30-40% of Carpet Call business;
- (c) Carpet Call import carpet and will not buy from Godfrey Hirst;
- (d) For year to date his purchases from the Company are \$1million over and above last year's;
- (e) 40% of Carpet Call's business is in timber flooring – he has had strong growth in this area;
- (f) There is no formal distribution agreement.

⁵⁰⁸ DD1 000534 at 537. See NOE (Meredith) page 727, line 25 to page 728, line 18; NOE (Feeney) page 2493, lines 17 – 28.

⁵⁰⁹ Feltex were forecasting A\$304,082,000 in sales (CB11 007831). Therefore Carpet Call provided 6.25% of Feltex's total sales. Further, if Solomon Franchises A\$2.23 is included then the total % of Feltex's sales is 6.98%.

25.19 The Group Sales Report for June 2004 & July – June 2004 Year provides a breakdown month by month of Carpet Call & Solomons combined. The breakdown also includes a variance analysis of the FY2003 sales revenue to FY2004 sales revenue. The extract is reproduced below. It shows falling sales to Carpet Call and Solomon each month (except for August 03 and November 2003) and every month from December 2003 to June 2004:⁵¹⁰

VARIANCES

2003 / 2004 Vs 2002 / 2003

	JUL	AUG	SEP	OCT	NOV	DEC	JAN	FEB	MAR	APR	MAY	JUN	PROG TOTAL
INVICTA COMMERCIAL	(\$22.2)	\$6.8	\$4.4	\$38.1	\$4.5	\$2.8	(\$0.3)	\$3.4	\$31.2	\$3.5	(\$30.3)	(\$16.2)	\$25.7
FELTEX COMMERCIAL	(\$7.8)	(\$21.2)	\$8.2	\$19.7	\$1.1	\$14.5	(\$4.7)	\$14.3	(\$7.7)	\$21.2	\$19.9	\$48.3	\$105.9
FELTEX PREMIUM					\$6.5			\$0.1		\$0.2			\$0.9
FELTEX DOMESTIC	\$63.8	\$86.9	(\$246.1)	(\$38.5)	(\$28.3)	(\$163.2)	(\$50.6)	(\$157.5)	(\$230.2)	(\$485.6)	(\$187.7)	(\$226.6)	(\$1,644.6)
INVICTA DOMESTIC	(\$88.4)	(\$3.7)	(\$40.9)	\$49.3	\$111.9	\$23.3	\$0.8	\$35.7	\$56.4	(\$22.7)	\$101.1	\$132.0	\$353.8
REDBOOK	\$33.5	\$393.0	\$6.6	(\$92.9)	(\$54.3)	(\$104.3)	(\$159.7)	(\$64.1)	\$15.2	(\$386.4)	(\$504.1)	(\$225.6)	(\$1,143.2)
MINSTER	\$76.3	\$158.0	\$101.0	\$111.8	(\$34.7)	(\$88.5)	(\$32.2)	(\$76.1)	(\$93.7)	(\$228.5)	(\$50.7)	(\$134.3)	(\$271.6)
	(\$21.9)	\$480.8	(\$267.8)	(\$24.3)	\$35.5	(\$227.0)	(\$214.5)	(\$166.1)	(\$135.0)	(\$849.5)	(\$501.2)	(\$286.0)	(\$2,573.0)

25.20 The report further records that in FY2003 the combined sales to Carpet Call and Solomons combined was A\$21,317,2000. This is consistent with the figures provided by Mr Lyons that Carpet Call annual revenue is A\$19m and Solomons is \$2.23m. However, sales revenue for FY2004 declines to A\$18,741,800 which is a decline of A\$2,573,000 (recorded in variance table produced above). This is inconsistent with the information provided by Rod Lyons to the due diligence committee on 2 April 2004. These matters were put to Mr Tolan in cross examination⁵¹¹.

25.21 The extract above also records that the combined purchases of Carpet Call and Solomons from December 2003 have decreased every month against the previous years purchase. This trend is also consistent with the timing and negative impact the removal of the guarantee of Carpet Call's banking facility had on Feltex's relationship with Jim Smith.

25.22 Mr Magill sent a memorandum to the board on 5 October 2004 where he recommends that Feltex divest their ownership in Carpet Call and agree to a dividend payment. Mr Magill supports his contention that Carpet Call was moving business from Feltex Carpets by attaching the extract from the Group Sales Report which records the month by month sales for Carpet Call & Solomons to September 2004. An extract of Mr Magill's memorandum is

510

CB17 012663 at 12683. See NOE (Meredith) page 726, line 11 to page 727, line 20

511

Tolan NOE 1677 line 26 to 1685 line 23

set out below:⁵¹²

Over the last 3 years we have had numerous discussions during the Board meetings in relation to our retail investment, and our trading relationship with Carpet Call; despite our best endeavours it appears that Jim Smith is determined to continue to move business from Feltex Carpets. I have attached the details of his sales performance over the last two years which show a reduction in Carpet Call and Solomon's purchases of Feltex products. I also attach a recent document from Carpet Call Queensland State Manager where he has communicated to Solomon's franchisees that we are an unreliable supplier of our polypropylene product Kings Domain. At the time of this communication we had ample stocks and this statement is incorrect. This demonstrates the negative impact of the move within the Carpet Call business to Feltex.

- 25.23 The board were aware of the difficult relationship with Carpet Call. They were aware that Jim Smith was temperamental. They knew from correspondence with Carpet Call that they strongly opposed the removal of the bank guarantee. The board was made aware that Jim Smith had negatively responded to the guarantee being removed, noting the objection was the principal of the matter. Finally, the board were aware or ought to have been aware that combined purchasing of Solomon and Carpet Call, which was their largest individual customer and that they owned a 50% share in, had declined (against the prior year) in every month from December 2003 to April 2004 and that sales had only been exceeded in two months against the prior years sales.
- 25.24 Submitted that Feltex ought to have disclosed to shareholders in the prospectus that it had a difficult relationship with their biggest residential customer, in which they owned a 50% interest, and that the projected financial performance would be materially adversely affected by this change in trading from Carpet Call and the projection was no longer achievable. It is not apparent where Feltex could find another customer to replace the quantum of sales (and margin) that Feltex had lost from Carpet Call up to May 2004, in May 2004, and foreseeably immediately thereafter.
- 25.25 Subsequent to the IPO, Carpet Call & Solomon's combined purchasing in FY2005 declined to A\$15,378,300 and consequentially the margin earned by Feltex also decreased.⁵¹³
- 25.26 Mr Saunders suggested that Carpet Call's business increased its importing of hardwood and held their levels of carpet, such that they were not going off

⁵¹² CB18 013105. See NOE (Tolan) page 1683, line 7 - 25
⁵¹³ CB19 013989 at 14009

and buying more from Feltex's competitors.⁵¹⁴ This is inconsistent with Mr Magill's written statement on 5 October 2004 that

"Jim Smith is determined to continue to move business from Feltex Carpets".

25.27 Submitted the deteriorating relationship with Jim Smith, which was accelerated by the withdrawal of the bank guarantee, was a materially adverse circumstance which Feltex ought to have been aware of by 4 May 2004 and revised its prospective figures given their largest customer had a declining sales trend throughout FY2004.

Feltex had a fairly high break even cost structure

Mr Magill

25.28 Mr Magill agreed in cross-examination with what Mr Saunders had said in his address at the AGM on 1 December 2005 that the carpet industry has a fairly high break even cost structure and that once you go through this break even point the margin on incremental production is very high and flows directly to the bottom line. The reverse also applies.⁵¹⁵

25.28 When it was put to him this was not something that a reader of the prospectus was informed about, Mr Magill said that he did mention that at some of the presentations before the IPO:⁵¹⁶

25.29 Mr Magill then said that:

Well I can only relate Your Honour to some of the presentations I did before the IPO, um, I did mention that the carpet companies have huge capital investment, they have high cost structures, and I explained to those meetings that when you went through the breakeven point you made a lot of money very quickly. Obviously if you didn't get the sales, the revenue, then obviously, because of the high breakeven cost then it would go into losses so I did explain that to the brokers, I did explain at the meetings that I attended so as far as I was concerned I had highlighted that to the investors prior to the IPO.

Mr Magill agreed:

There's nothing in the Prospectus that specifically states that, that is correct sir.

⁵¹⁴ NOE page 2128, line 17-24

⁵¹⁵ NOE 1905/18-24

⁵¹⁶ NOE 1905/27-1906/2

He nevertheless agreed that it was important to tell this to the brokers.⁵¹⁷

Mr Cameron

25.30 Mr Cameron was asked in chief to comment on whether there should have been disclosure in the prospectus because Feltex was a manufacturing business it had high fixed costs. He agreed. He said nearly all manufacturing business have high fixed costs. He said:

For sophisticated investors they would clearly understand that business is like that with large workforces, large operations, a high fixed cost and that clearly if they had significant downturns that leads to pressure on margins. If they have upswings in demands the opposite happens but not a – [sic] you would expect investors and brokers to know that, as a general case.⁵¹⁸

25.31 In cross-examination Mr Cameron agreed with the question that:

...when you break through the barrier you start making money very quickly but when you don't make it to that barrier you start losing money very quickly.⁵¹⁹

25.32 Mr Cameron said that sophisticated investors would understand this but when it was put to him that retail investors may not he said:

They may not understand that.⁵²⁰

25.33 He agreed that for someone who doesn't speak to a broker and who relies solely on the prospectus they may not understand that.⁵²¹ Submitted there would be likely to be retail investors in this category.

26. Second Bottom Line – 4ASOC para 45

FRS 29

26.1 The financial reporting standard covering preparation and presentation of general purpose prospective financial information at the time of the Feltex IPO was FRS-29 Prospective Financial Information, first issued in 1996⁵²².

26.2 FRS 29 applies only to the audited financial information in the

⁵¹⁷ NOE 1905/30 1906/9
⁵¹⁸ NOE 2379/18-28
⁵¹⁹ NOE 2379/30 – 2380/1
⁵²⁰ NOE 2380/2-6
⁵²¹ NOE 2380/9-11
⁵²² CB1 000711

prospectus.⁵²³ It does not apply to management’s discussion and analysis within an entity’s financial report, such as the discussion which occurs at pages 81 to 83 of the prospectus.

26.3 The principal paragraphs of FRS 29 that apply to the issues that arise in respect of pages 85 to 92 of the prospectus are in the section of the standard, Presentation of Prospective Financial Information, in particular paragraphs 5.1, 5.3, 5.4 & 5.5

26.4 Paragraph 5.1 provides:

“General purpose prospective financial information shall be presented in the format expected to be used in the future for reporting historically oriented general purpose financial reports.”

The Standard does not specify any particular format for any financial statement whether the information is historical or prospective. However paragraph 5.1 requires the information to be presented in the format expected to be used in the future for reporting historically oriented general purpose financial reports.

26.4 In order to establish the format expected to be used in the future, reference can be had to the way in which historically oriented financial information was presented in prior years ⁵²⁴ and how historically oriented financial information was presented by Feltex in the prospectus at pages 96 to 114. Reference can also be made to how the historically oriented financial information was presented in the 2004 Annual Report⁵²⁵. In each of these cases the format of the presentation of the consolidated statement of financial performance is substantially the same. The bottom line is “Net surplus/(deficit) attributable to shareholders”. It is not an adjusted figure such as appears in the second bottom line on page 85. Professor van Zijl considers that as no format is required by FRS 29 that it is permissible to use the format that appears on page 85 of the prospectus. ⁵²⁶ This opinion fails to take into account the requirement of the standard that the format is to be the same as the format expected to be used in the future. It also fails to take

523 Paragraph 2.3 FRS 29
 524 CB6 004474 @ 004498 to 004514
 525 CB17 012265 @ 012296 to 012326
 526 Van Zijl brief paragraphs 24 & 25

into account the principles approach supported by release 6 of the Accounting Standards Review Board (ASRB6). **527** It was well known what is meant by the bottom line figure and that it should be at the bottom. None of the internal management accounts or the historically oriented financial statements prepared by Feltex utilise the second bottom line as on page 85 of the prospectus

- 26.5 Paragraph 5.3 specifies that prospective financial information shall be presented as a statement of prospective financial performance and a statement of accounting policies and may also include statements of prospective movements in equity, prospective financial position and prospective cashflows.
- 26.6 Paragraph 5.4 identifies the items required to be disclosed in a statement of prospective financial performance. Notably the last item in the list (g) is net surplus (deficit). Examples of formats for statements of financial performance can be found in FRS 2 Presentation of Financial Reports Appendix 1. **528**
- 26.7 Paragraph 5.4 does not prohibit reporting of items additional to the required items. This is accepted by both Professor Newberry and Professor van Zijl. Earnings before interest and income tax ("EBIT") is an example of an additional item that may be reported in statements of financial performance. The Feltex Prospectus includes EBIT in both the Statement of Prospective Financial Performance (page 85) and the statements of historical financial performance (pages 93 to 96). However EBITDA (before or after write-offs) is not used in the statements of historical performance in the prospectus.
- 26.8 Paragraph 5.5 (b) requires the separate disclosure of:

"Items included in operating revenue or operating expense if they are of such incidence and size, or of such nature, that their disclosure is necessary to explain the prospective financial performance of the

527 ASRB6 para 9 states "The Board urges reporting entities ... to recognize and comply with the spirit and purpose of generally accepted accounting practice and not solely on the "black Letter" of approved financial reporting standard." Professor van Zijl was a member of the Board. ASRB6 was put to the Professor in cross-examination at NOE page 2567 lines 6 to 23

528 CB3 001939 @ 001960

entity. An adequate description of each item shall be given to enable its nature to be understood.”

This is the concept of materiality. **529**

Page 85

26.9 Accordingly the identification of the expenses associated with the redemption of the bonds in FY 2004, being items of such incidence and size and of such nature are properly disclosed separately in the statement of prospective financial performance. What is objectionable is the adding back of those items and presenting the adjusted figure as a second bottom line placed within two bold black lines.

Further the statutory net surplus of \$10,113 million and \$23,889 million should sit immediately above the statement of prospective movements in equity, where the same figures are shown as the first movement. As Professor Newberry noted:

These are the things that the directors have chosen to highlight on the page. If there were one-off gains, or what they thought were one-off gains, they could have chosen to highlight them. This is just little pieces of information from the whole ledger and it's a presentational issue, it's not going to change the net surplus attributable to shareholders. And may I, just, just, because I've been saying this doesn't balance – would you look down the page at this consolidated statement of prospective movements in equity and that starts with equity at the beginning of the year and then it says, "Net surplus for the year of 10,113,000," just further down on page 85. And you see that's the only way the financial reports can balance. That then goes through to equity at the end of the year and if you go through to the consolidated statement of prospective financial position then you see equity attributable to shareholders of 90,250,000 which is the same as the figure at the bottom of the statement of consolidated movement, prospective movements in equity. If you try to change that figure to 22 million you won't balance it. It would be out of balance.

530

26.10 Also objectionable is the description of this adjusted second bottom line figure as a Net surplus attributable to shareholders. FRS 2 paragraph 4.6 defines net surplus (deficit)

“is the sum of an entity’s operating surplus (deficit)⁵³¹ and extraordinary items”

As described by Mr. Meredith in answer to a query from Your Honour:

*“Well it might be that you, Your Honour that that line item is called something else like, well I’m trying to search for another name for it but it’s, it’s not ever a net surplus attributable to shareholders. Because a net surplus attributable to shareholders has a, you know has a particular meaning.” **532***

26.11 Whatever the adjusted figure is, it cannot be described as a net surplus attributable to shareholders, as the adjustments made add back items which have already been deducted to arrive at the net surplus. The description given to the second bottom is not logical and is an example of Aristotle’s law of non- contradiction.

“It is impossible for the same thing to belong and not to belong at the same time to the same thing and in the same respect”⁵³³

26.12 An explanation of the adjustment of the statutory net surplus (if required) could have been included as a note to the prospective financial performance statement, **534** but can never be described as a “net surplus attributable to shareholders”. The adjustments made to net surplus have been or will be expended and are not attributable to shareholders.

26.13 Professor Newberry opines that the second bottom line is misleading to a notional investor. She describes her understanding about how a notional investor would read the statement of prospective financial performance as follows:

Q. “Given that you have accepted that there's nothing, as I understand it anyway, else apart from the second bottom line misleading about this page, you would expect, would you not, the notional investor to have a reasonably clear understanding of what the \$10 million was?”

531 CB3 001939 FRS 2 Paragraph 4.9 provides: “operating surplus (deficit)” is a measure of financial performance resulting from transactions and other events during a period, excluding:
 (a) changes in equity resulting from the effect of extraordinary items;
 (b) changes in reserves recognised in the statement of movements in equity;
 (c) currency translation differences permitted to be recognised in the statement of movements in equity; and
 (d) distributions to and contributions by owners.

532 Meredith NOE page 591 lines 10 to 14
 533 <http://plato.stanford.edu/entries/aristotle-noncontradiction/#1>
 534 Newberry NOE page 352

- A. *“I would expect the notional investor to scan through this, here’s earnings, here’s earnings, there’s earnings, earnings, earnings, operating surplus, net surplus, net surplus attributable shareholder, there’s one, two, three, four, five before we get to the second bottom line, bolded lines that talk about some sort of profit. Up, higher up, it’s earnings and then as we get towards the bottom it’s operating surplus before income tax and net surplus after income tax and then net surplus attributable to shareholders and those last three are required in the accounting standard. So I would expect a retail investor who doesn’t know much, there’s all these earnings, I don’t know which it is, I’ll go for the bottom line. That’s how they are likely to see it.”*⁵³⁵

And later

- Q. “But they are specifically mentioned, one by one, in the lines at the top part of the page?”
- A. *“As I’ve already said there are so many figures, all in bold, that, that say they are either earnings or net surplus and a reader who doesn’t know, who’s seeing these audited statements is likely to say, “I don’t know which is which, I’ll go for the bottom line.”* **536**

26.14 Nevertheless, Professor van Zijl opines that the second bottom line is helpful to readers of the prospectus in making an assessment of Feltex’s future financial performance⁵³⁷. His opinion is supported by Mr. Cameron.⁵³⁸ However none of the prospectii referred to by Mr. Cameron in his brief at paragraph 38 Table 1 utilize the format of page 85 in the audited prospective financial information.⁵³⁹ The question must be asked “helpful to whom?”

26.15 While the defendants’ witnesses argue that it is helpful to an investor, the stark reality is that it is helpful to the vendor and Feltex in selling the offer and the JLM’s in promoting the offer. The second bottom line boosts the FY04 forecast profit such that it looks more attractive and importantly as \$22.307 million is a number of similar magnitude to \$25.873 million, it provides support in terms of credibility to the FY05 number.⁵⁴⁰

26.16 This relativity was accepted and understood by Mr. Thomas when he was

535 Newberry NOE page 336 line 29 to page 337 line 9
 536 NOE page 337 line 23 to 28
 537 Paragraph 41 of his brief
 538 Paragraph 51 of his brief. It should be noted that while Mr. Cameron is an experienced merchant banker and financial analyst, he has no expertise in respect of Financial Reporting Standards.
 539 Copies of these prospectii were provided on USB to the Court and the defendants during Mr Cameron’s cross examination
 540 Meredith brief paragraph 301 (a)

cross-examined.541

Q “You don’t dispute it could have been presented separately and clearly explained why it’s being presented?”

A. *“Not if what’s left on this page, unexplained, is 10.1 million to 23.9 million. That is just unrealistic.”*

26.17 Certainly a sophisticated investor would not require the second bottom line to understand the effects on financial performance of the costs of redemption of the bonds. The separate items being stated so clearly would be readily understandable by a sophisticated investor. Professor Cornell addressed this in cross-examination **542**:

A. *“Yeah, if anything I see it as a useful tool that management is providing that a sophisticated investor can choose to adopt or not adopt, use, not use, as long as the numbers are right. I see these types of numbers all the time, I’m grateful they’re there, in some cases I agree with them, some cases I don’t.”*

Q. But if the figures are correct that I’m putting to you, and I understood your evidence when you touch on this aspect of the plaintiff’s claim, can’t have any direct influence on the value of the company, it’s just the impression gained as to what is the net surplus attributable to shareholders, what does that mean and why are there two lines there?

A. *“No, I agree that it, I mean, the reason they’re, just let me explain a little, the reason there are two lines. When you’re trying to present past information or short-term forecasts, your goal is to help the investor understand how the business is going to perform going forward, because that’s what determines its value, and if the current and past data are not indicative of what the future might look like – again, I like sports analogies – suppose we’re evaluating a player who last year played with a hamstring injury, and if you took their figures and just said, “Well, that’s how they’re gonna do next year,” you’d be misled. So you adjust them to say, “Had that injury not occurred it would have been different.” I think that’s what the company is trying to do. But the point of my evidence was, sophisticated investors won’t be misled by this –“*

Q. No.

A. *“-They can take it or leave it and make their own judgements.”*

Q. The average investor might be, however, it’s possible isn’t it, that the presentation of those two lines could be confusing?

A. *"I'm not an expert on retail investors, but I wouldn't be surprised if a retail investor might be confused in some cases."*

- 26.18 In order to consider the effect of presentation of the double bottom line, a comparison can be made of what page 85 would have looked like had the additional information been conveyed as notes to the accounts.
- 26.19 Set out below is a recast page 85 with the appropriate bottom line Net surplus attributable to shareholders. Note 1 refers to SIP grants which is addressed in paragraph 35 of the submissions. Note 3 refers to the dividend structure which is addressed at paragraph Y of the submissions. Note 2 explains the adjustments otherwise made in the second bottom line. Arguably the net effect of rapidly increased extended credit sales/forward dating on the operating revenue for the period should also have been included as a note on page 85. 543 This is addressed at paragraph 24 of the submissions.



FELTEX CARPETS LIMITED		
CONSOLIDATED STATEMENT OF PROSPECTIVE FINANCIAL PERFORMANCE		
FOR THE YEARENDING	FORECAST JUNE 2004 \$000	PROJECTION JUNE 2005 \$000
Total operating revenue - (note 1)	335,498	348,147
Earnings before interest, tax, depreciation, amortisation and write-offs EBITDA (note 2)	41,641	51,683
Depreciation	(8,076)	(8,427)
Earnings before interest, tax, amortisation and write-offs	33,565	43,256
Amortisation of goodwill	(1,958)	(1,984)
Write-off of bank facility fee	(341)	-
Write-off of Bond issue costs	(4,881)	-
Earnings before interest and income tax	26,385	41,272
Interest expense	(13,307)	(7,526)
Early Redemption Amount	(5,014)	-
Operating surplus before income tax	8,064	33,746
Income tax benefit / (expense)	649	(11,335)
Net surplus after income tax	8,713	22,411
Share of retained surplus of associate companies after income tax	1,400	1,478
Net surplus attributable to Shareholders	10,113	23,889

FELTEX CARPETS LIMITED		
CONSOLIDATED STATEMENT OF PROSPECTIVE MOVEMENTS IN EQUITY		
FOR THE YEARENDING	FORECAST JUNE 2004 \$000	PROJECTION JUNE 2005 \$000
Equity at beginning of year	16,652	90,250
Total recognised revenues and expenses		
Net surplus for the year	10,113	23,889
Foreign currency translation reserve	(159)	-
Revaluation reserves	15,394	-
Contributions from owners		
Shares issued	50,000	-
Issue costs	(1,750)	-
Distribution to owners		
Dividends (note 3)	-	(16,806)
Equity at end of year	90,250	97,333

1. Feltex received SIP payments of \$4.7 million in the 2004 financial year, which are included in operating revenue. SIP receipts are projected to be \$1.85m in 2005 (refer page 50, and specific assumption page 92).
2. Write offs of bank facility fee and Bond issue costs and the cost of Early Redemption (total \$10.236m) have been included gross in Forecast 2004 EBITDA then deducted.
3. Dividends of \$9m payable September 2004 for y/e 2004, and for y/e 2005 \$7.8m payable March 2005 and \$11.7m payable October 2005 are projected (refer page 11). Total projected dividends payable by June 2005 are \$16.8m, as above, plus \$11.7m payable in October 2005; total \$28.5m.

FELTEX CARPETS LIMITED 85

26.20 The starkness of the visual presentation of page 85 with the statutory bottom line demonstrates clearly why Carolyn Steele for the JLM's544 recommended by email on 7 April 2004:

“it will assist the marketing of the Offer to include normalized EBITA and NPAT figures. We recommend including an EBITA line prior to the Amortisation expenses and also a “Net surplus (deficit) attributable to shareholders of the company (before Amortisation and Bond Call Premium)” as the last line item in the P&L to show a Normalised NPAT figure”

26.21 Despite the protestations of the defendants’ witnesses that the pro forma terms were included to be helpful, it is clear that the purpose of the pro forma terms on page 85 (and inferentially elsewhere) was simply the stated purpose of marketing the offer – that is improving the appearance of the financial position and forecast performance of Feltex by putting a sales pitch into the “audited” accounting.

Marketing themes in the prospectus

26.22 The same theme regarding presentation of Feltex’s financial information can be drawn from the presentation made by FNZC to Credit Suisse in October 2003 545. In order to divert attention, FNZC advised developing a credible list of mitigants, including emphasis on the unusual circumstances behind the company’s poor financial performance and the synergies from the merger.

26.23 At intrinsic page 3 of the October 2003 presentation “Selling the Feltex Story”:

- *the story should support the forecasts and the forecasts must be credible in light of historic performance.*

As observed by Mr Russell under cross-examination by Mr McIntosh⁵⁴⁶, the Feltex story was sold effectively in the front part of the prospectus:

“Page 19, which is obviously much closer to the front of the Prospectus and, as I think I said earlier in my evidence, there were, there was an awful lot of information put between the sales pitch at the front and the numbers at the back. My conclusion, and I think my early notes, which are in that bag there, say that this is two different companies. Page 19, if one looks at that flow of numbers, 2002, 2003, 2004, 2005, this is not the same company as one looks at page 93 and as I think I said in my earlier evidence, a lot of retail investors they probably would’ve given up somewhere between, when they

545 CB7 005231 @ CB005235
546 Russell NOE page 1093 line 14 to line 28

started to get into a lots of words and some pretty pictures, they would've given up and they would walk away with the view that this was, in fact, the growth company and that's actually saying at the operating revenue line but if you look at the next two lines, EBITDA and EBITA, you even come up with a much stronger view that this is a growth company, not a mature company.”⁵⁴⁷

26.25 In a letter from FNZC to Mr. Saunders and Mr. Thomas dated 19 December 2003⁵⁴⁸, Mr. Hamilton advises to position Feltex using four broad investment themes:

- the business has been stabilized
- Feltex has robust market positions
- Further earnings growth is forecast
- Feltex will generate strong free cash flows

The tool used to convey these themes is modified EBITDA which is addressed at paragraph 34 of the submissions.

26.26 The joint JLM presentation IPO update dated April 2004⁵⁴⁹ “Basis for Determining IPO Valuation” at intrinsic page 3 after discussing valuation approach refers to:

- Need to demonstrate that FY2004 earnings are “in the bag” and focus investors on FY2005 projections

⁵⁴⁷ As to the structure and content of the prospectus see Russell NOE Page 1059 line 10 to 29:

“I, I prefer to say that I would go further and as one sits here at the moment you try to filter through Prospectus’ but I remember when I looked at the Feltex IPO Prospectus I immediately noticed a structure in the Prospectus that I’d not seen employed previously and, and I would discourage anyone to, to use that structure. And I felt the structure of the Prospectus left a lot to be desired, and as I explored and tried to reconcile numbers, and as I’ve said, reconciling the numbers is not my expertise, but as I, as a user of Prospectus’ and Annual Reports, tried to reconcile those numbers, I found it very difficult and I found the document very cumbersome and I felt that there was an awful lot of data between the sales pitch upfront and the accounting statements down the back where there was an awful lot of data where I would have, you know, put in the back of the Annual Report because your average mum and dad wouldn’t continue to turn the pages and ever get to those numbers. Now your sophisticated investor would get to those numbers, but again I found the numbers were in such an unhelpful format that, I mean, this is why if the Court decides that their conclusions are not proven then who am I to question that, but as a user of an I – of prospectuses and annual reports, I know that I would be questioning the parties involved in the preparation of this document.”

⁵⁴⁸ CB8 005783 @ 005784

⁵⁴⁹ CB10 007535 @ 007538

- Need to demonstrate sustainability of FY2005 earnings and further growth potential above this level

26.27 At intrinsic pages 18 to 22550 the JLM's set out the Key Marketing Themes – each of which appears in the prospectus at pages 7 and 15. The themes are clearly directed at focusing the readers attention on the mitigants to the poor historical performance identified in earlier presentations:

- Feltex has a long- standing and successful operating history
- Operational strategies successfully implemented
- ...positioning Feltex as a responsive service- oriented manufacturer of significant scale
- ...excellent investment features – solid core earnings and potential earnings growth...

Target market

26.28 It is clear from the evidence that the target market for the Feltex IPO from its inception was the retail market. Forsyth Barr's initial presentation of 23 December 2003 551 at intrinsic page 9:

"We expect there will be strong demand for a Feltex IPO on the NZX particularly from retail investors:"

The 23 December 2003 presentation then sets out in table form Forsyth Barr's estimate indicative IPO demand. Total retail demand was assessed to be \$130-\$190 million. Institutional demand was assessed to be \$50 to \$90 million.⁵⁵²

26.29 The 23 December 2003 presentation at intrinsic pages 104 to 114 Forsyth Barr's presentation sets out an overview of Forsyth Barr:

- Page 105 – NZ's largest sharebroker with 85 advisors spread nation wide; strong emphasis on client relationships with over 40,000 active

550 CB10 007535 @ 007553 – 007557

551 CB7 005446 @ 005455

552 See also instrinsic pages 55-57 CB7 005501- 005503

clients; over \$1.2 billion of discretionary funds under management via our Private Portfolio Management and Wholesale Funds Management services; recently established institutional equity capability

- Page 106 – excellent relationships with the NZ broker network, financial planners and domestic institutions
- Page 107 – Forsyth Barr has unmatched retail distribution capability with over 100,000 clients and over 40,000 active retail clients and \$1.2 billion of discretionary funds under management
- Page 108 – Forsyth Barr’s distribution capability given its large NZ retail network

26.30 This emphasis on retail investment is repeated in the presentation on 4 February 2004⁵⁵³ but Forsyth Barr make the additional pitch at intrinsic page 3 that a large proportion of Feltex bond holders are Forsyth Barr clients.

26.31 Mr. Paviour-Smith under cross-examination confirmed that Forsyth Barr considered that there would be greater demand from retail investors and marketed its retail client base as a reason for their appointment.

“Well, there’s no doubt that our firm’s position in the New Zealand marketplace, and we’re only a New Zealand firm, an investment that I’d led and the firm had committed to over many years and building up our position as, at the time, the largest NZX firm in terms of numbers of private client advisors, gave us an ability to distribute offers of securities more widely than other firms and so in a competitive environment that’s certainly a feature we would be putting in front of prospective clients, just as other firms would probably refer to their relative strengths as well.”

And

“I wouldn’t say principally aimed at retail client base. I think we’ve referred in a number of places that we thought that it was more likely the offer would have, would receive greater demand from retail investors but it was certainly intended to be aimed at a wide range of investors, including institutions both domestically and off-shore.”⁵⁵⁴

Second Bottom Line – Misleading or Deceptive?

553 CB8 006172
554 Paviour-Smith NOE page 3136 line 14 to page 3137 line 5

26.32 Professor Newberry considers that the presentation of the statement of prospective financial performance breaches FRS 29. She was cross examined extensively by Mr. Cooper and Mr. Smith QC. Her opinion is clearly set out in answer to questions from Mr. Cooper:

Q. Do you accept that one purpose of presenting the figures in this way with the 2004 figures in one column and the 2005 figures in the other column is to allow a reader to compare the two years?

A. *No. I don't and my concern is about this, this is the information that's audited, this is related to the Financial Reporting Standards. As I've said in my document, to me this is a breach of the Financial Reporting Standards, it is at odds with the intent of the Financial Reporting Standards to focus on that net surplus attributable to shareholders.*

Q. So I don't think any of that addresses my question. Do you accept that one purpose of presenting one year's figures beside the next year's figures is to allow a comparison between the two?

A. *No I don't. And the reason I don't is that all of the material in the earlier part of the Prospectus allows the directors to say whatever they like. This is the audited material and I would expect it to comply with the Accounting Standards. In my view this does not comply.⁵⁵⁵*

It was accepted by Professor Newberry that the second bottom line would not mislead a sophisticated investor.⁵⁵⁶ However, because the amounts had been disclosed clearly on page 85, such an investor would not need to have the adjustments added back to create a second bottom line.

26.33 Professor Newberry considers that an unsophisticated investor could well be misled by the inclusion of the second bottom line.⁵⁵⁷ Professor van Zijl appears to hold the view that nobody who could read would be misled by the second bottom line.⁵⁵⁸ However he does acknowledge that a bottom line means profit in a statement of financial performance.

Q. "Well an unsophisticated investor, Professor van Zijl, would simply go to the bottom line and look and see well that's my net surplus, that's my profit won't they?"

A. *"Well if they're so unsophisticated then would they actually*

555 Newberry NOE page 203 line 23 to page 204 line 4

556 Newberry brief para 39 and NOE page 351 line 14 to page 352 line 9

557 Newberry brief para 19

558 Van Zijl NOE page 2561 line 17 to page 2562 line 22

understand what “net surplus” means?”

Q. “Well normally a bottom line means profit doesn’t it?”

A. *“In a case of a statement of financial performance, yes.”*

26.34 Mr. Houghton in answer to questions from counsel about his perception of the two bottom lines answered⁵⁵⁹:

“Well my natural want would be to go to the bottom, to the second line, and I’m quite confused about the description. I mean, I look at the net surplus through to the shareholders in the first, the first of those two, and it tells me it’s 10,000, sorry, 10 million and then I drop down here and it’s 22 million but it seems to have some sort of proviso as to what 20 that means and I’m not, I’m not really sure what, I’m not quite sure how to read the difference between those two figures. Because on one hand I’m being told there’s 10 million and then the next I’m being told there’s 22 million before these things.”

Mr Forbes QC: Do you have any comment on the figures themselves?

“The, um, I’m noticing that the first, the first set of figures is 10 million to 23.8, I believe, which seems like quite a leap, and the lower figure, 22.3 to 25, um, I’m just, that, the lower figure, to me, seems quite realistic, I just think, okay, so this amount attributable to shareholders. We’ve got 2004, we’ve got 22, next year we’ve got 25. I see that as quite achievable and realistic prior, in the way I look at it. If I go back to the other one, that’s over double, between 10 million and 23, which, there’s something about that I find – there’s more information needed to help understand how it could go so much bigger between 2004 and 2005”

Later under cross-examination from Mr. Galbraith QC⁵⁶⁰ he demonstrated that even a university graduate would not necessarily understand the second bottom line or the pro forma terms used on page 85 (and elsewhere) and required Mr Galbraith’s assistance to understand page 85. Most tellingly Mr. Houghton answers:

“When I’m looking at this page, the only thing that is mattering to me is what the total is at the bottom.”⁵⁶¹

26.35 Mr Cameron under cross-examination admitted that unsophisticated investors seldom read the prospectus through⁵⁶² and would not necessarily understand financial statements⁵⁶³ both historical or prospective. Thus they are the investors most likely to be misled by the second bottom line.

559 Houghton NOE page 54 line 16 to page 55 line 7
 560 Houghton NOE page 78 line 13 to page 83 line 4
 561 Houghton NOE page 80 line 1
 562 Cameron NOE page 2420 at line 26
 563 Cameron NOE page 2424 at line 6

Further, retail investors assess the financial information in the prospectus on the quality of the persons “certifying the information” – the brokers and the directors.⁵⁶⁴

26.36 Professor van Zijl considered that an unsophisticated investor should seek the advice of a financial planner or other professional adviser if they do not understand. The problem with that position is how does an investor know:

- They don’t understand what they are reading; or
- What they are reading is not industry standard information; or
- What they are seeing is not what it appears to be – the bottom line profit figure.

26.37 The target market is the retail investor. The marketing themes drive the reader to the future performance of the company and divert the attention away from the historical performance of the company. The second bottom line does the same thing – it adds back the cost to the company of the borrowing for the bonds to present a better financial result. The second bottom line makes the FY05 projection look credible.

26.38 The bottom line is understood by all investors and is a common everyday and easily understood expression. It is used by people in their everyday lives. It is where the profit figure lies in a financial statement. Presenting an adjusted pro forma figure where the statutory profit figure would in normal circumstances be found will lead readers into error unless they have the skills to recognize and understand that this is not what it appears to be: the net surplus attributable to shareholder.

27. **EBITDA – 4ASOC para 36**

27.1 Mr Meredith at paragraph 202 of his brief accepts that EBITDA is an important measure of financial performance since it can generally be interpreted as a proxy for operating cashflows, but he considers:

“EBITDA should not be viewed in isolation; other measures of financial performance, such as NPAT and sales, should also be

⁵⁶⁴ Cameron NOE page 2432 line 3 to page 2433 line 8

considered when assessing the performance of a business.”

27.2 Mr Cameron at paragraph 34 of his brief agrees with Mr. Meredith

“The purpose of EBITDA is to focus on the operating performance of a firm. I agree with Mr Meredith’s generalisation (para 202) that EBITDA “can generally be interpreted as a proxy for operating cashflows”. It is a rough measure of the revenues less cash operating costs and is a useful measure in that regard for comparing the underlying performance of a firm year on year and for comparing firms across the same or similar industries.”

27.3 However, Professor Robb at paragraph 31 of his brief considers that EBITDA in the prospectus appears to be used as a measure of profitability and considers that this is not appropriate.

In the Feltex prospectus EBITDA appears to be used as a measure of profitability. On page 15 the comment is made that “Feltex has successfully repositioned and focused its product mix towards the higher value and higher margin end of the product spectrum. This has resulted in significantly improved EBITDA.” I consider that EBITDA cannot be a meaningful measure of profitability when it omits indirect costs such as interest, depreciation, amortization, and taxation.

27.4 Professor Robb was challenged under cross- examination by Mr. Galbraith QC as to the general acceptance by financial analysts of the use of EBITDA.

Q. Because in fact financial analysts et cetera do tend to focus on EBITDA as a useful measure, don’t they?

A. *Believing it to be either an indication of cash, operating cash flow or a measure of profit but as I’ve said it is neither.*

Q. Yes but that’s the reality of the marketplace that in the marketplace that is how financial analysts and institutions et cetera do tend to regard EBITDA, despite your views?

A. *It is and I think the evidence is that it takes a time for some analysts to accept that some of the measures they’ve used are not good. We had a similar situation prior to the introduction of statement of cash flows. We’re required, under accounting standards, a statement of changes in SSAP10 was originally funds from operations, net profit add back depreciation was a figure that was required to be reported that was accepted by analysts as meaning something. It was very much like EBITDA, net profit add back depreciation. I wrote a piece criticising the concept when the collapse occurred in 1985, from memory, Perry Dines collapsed, they had a shortage cash from operations, no cash flow statements were required at that time. If they had been there would’ve early warning of the negative correlation between net profit add*

back depreciation and cash flows. The chairman of the Securities Commission at the time, in his report suggested that the institute or the Society of Accountants as it then was, should review that statement of changes in financial position and require a statement of cash flows. Professor Devonport from Canterbury and myself were asked to draft that statement, we did and that statement of cash flows then revealed, in a way that was never done before, the operating cash flows and their significance as an early warning for core companies getting into financial strife. So I've seen what happens with analysts who accept a number that involves an add back of depreciation but is quite misleading and that was the situation where we had Perry Dines collapses, we had PSIS getting into financial strife because it never produced cash flow statements, they weren't required. Had they been required to do so, there would've been early warning of the impending cash crisis. Similarly with Fortex. Now all of those were in my first report relating to this company and that's why I believe we should be very cautious about saying analysts look for EBITDA but I've yet to see how analysts ever use that to make informed decisions. End of lecture.565

27.5 EBITDA is known by some commentators as “everything but bad stuff”.

Warren Buffet is well known for rejecting the use of EBITDA as a means of analysis. Even Mr Cameron accepted that it was a starting place for analysis rather than a reliable measure in itself.

“I mean the issue around this in the end is, I mean one of the reasons I pointed to all these things, there is sort of a thing called “economic survival”. In markets where you have sensible practitioners, like the market model it survives because it has a good use and EBITDA as a value benchmark is not perfect but it survives because it's useful and sophisticated investors can take an EBITDA as a cash multiple and they can actually turn it into a discounted cash flow making all the adjustments. In fact I wrote an article for the Institute of Financial Analysts doing exactly that, it's good enough and it's the best that we've got and it's a comparable and its based on market data as one of my early, as one of my early instructors in the industry told me, Brian Gaynor as it turns out.”566

27.6 EBITDA, in its many variants, is used in the prospectus as a measure of performance and appears in the prospectus on pages 7, 11, 15, 16, 19, 41, 82, 83, and page 85. EBITDA is defined at page 143 as earnings before interest, tax, depreciation, amortisation and write-offs. Mr Cameron accepted that write-offs are not part of the standard industry definition EBITDA.567

565 Robb NOE page 527 line 4 to page 526 line 6
 566 Cameron NOE page 2421 line 24 to page 2422 line 2
 567 Cameron NOE page 2412 lines 17 to 30

27.7 The divergence of opinion regarding the use of EBITDA, the lack of utility of the measure from a notional investor's point of view and the expectation by the defendants that the target market was the retail investor must call into question the decision to use EBITDA so frequently in the prospectus. The fact that a non-standard industry version of the term is used can only add to the confusion.

27.8 Page 7 uses EBITDA in two different ways.
In the sentence:

“Feltex is projecting EBITDA of \$52 million in FY2005, an increase of 13% on forecast EBITDA (on a pro-forma basis adjusted for one-off items) of \$46 million in FY 2004.”

It is to be presumed that the first EBITDA is the defined term on page 143. – “Earnings before interest, tax, depreciation, amortisation and write-offs”. However the second use of EBITDA is adjusted on a pro forma basis, suggesting that perhaps the first use of EBITDA is the standard industry term.

Nowhere on this page is there an explanation as to what these one-off items are nor is there any direction as to where to find the one-off items. They cannot be the write-offs of bond costs as that would be a double up. When the reader goes to page 85 of the prospectus the forecast EBITDA is \$41 million, not \$46 million.

On the same page at the third paragraph there is mention of annual sales in excess of \$310 million. This wording is then repeated in the last paragraph on page 15 and followed immediately by the sentence:

“... this significant scale provides Fetelx with a competitive manufacturing costs base ...”

There is no reference at any stage to NPAT.

27.9 Page 11 in fact uses the standard industry definition of EBITDA. However this use is contradicted by the statement on page 3 of the prospectus

“Capitalized terms in this Offer Document have a specific meaning and are defined in the Glossary on pages 143 to 145 of this Offer Document.”

- 27.10 Page 15 and 16 of the prospectus repeats the statements made at page 7 and still does not explain what the one off items are.
- 27.11 Page 19 of the prospectus explains the one-off items that adjust the EBITDA and EBITA figures but does not give NPAT figures for 2002 and 2003. The table below sets out what the summary financials would look like if the 2002 and 2003 NPAT figures were included.⁵⁶⁸

SUMMARY FINANCIALS

12 MONTHS TO 30 JUNE	2002	2003	2004'	2005'
	ACTUAL 1000	ACTUAL 1000	FORECAST 1000	PROJECTED 1000
Total Operating Revenue	322,506	314,352	335,498	348,147
EBITDA	13,219	31,018	41,641	51,683
EBITA	3,894	23,175	33,565	43,256
NPAT <i>(before amortisation, write-offs and Early Redemption Amount)</i>			22,307	25,873

1. For further information on the forecast 2004 and projected 2005 financial information, including the assumptions underlying this summary please see 'Prospective Financial Information' on pages 85 to 92 of this Offer Document.

- 27.12 The focus of the management discussion and analysis of financial results at pages 82 and 83 of the prospectus is entirely on EBITDA. The EBITDA graph at the top of the page shows figures that have been adjusted for discontinued operations and one-off items.
- 27.13 In accordance with the strategy identified by the JLM's in their Key Marketing Themes,⁵⁶⁹ the prospectus focuses on core earnings or EBITDA, rather than profit and NPAT. This focus on EBITDA is acknowledged in the Bring Down Due Diligence meeting of 2 June 2004.⁵⁷⁰
- 27.14 As acknowledged by Mr. Cameron, retail investors do not understand EBITDA but might have a conversation with a broker who does⁵⁷¹. Mr. Russell considers that EBITDA is for sophisticated investors and that retail investors understand sales and net profit.⁵⁷²

⁵⁶⁸ This reconstructed table is an excerpt from the appendix to Mr Houghton's brief
⁵⁶⁹ CB10 007535 @ 007553 – 007557
⁵⁷⁰ DD2 000761 @ DD000754
⁵⁷¹ Cameron NOE page 2459 line 24 to page 2460 line 18
⁵⁷² Russell NOE page 1089 line 20 to page 1090 line 12

- Q. And as I understand it, Mr. Russell, that concern arises because as you've said in your paragraphs 22 and 32, investors pay close attention to sales and sales trends?
- A. *Agree*
- Q. You're not saying by that though, are you, that sales are the primary factor for investors in their decision making for an IPO?
- A. *It's one of the critical factors, it's not the only critical factor.*
- Q. Would you accept that they pay even closer attention to profits and profitability?
- A. *Absolutely.*
- Q. And measured in many cases by EBITDA results?
- A. *Yes, I'm an EBITDA man but again if you are asking for a fuller response on EBITDA-*
- Q. No, no I'm just asking that, whether you agree that for many investors EBITDA will be their primary focus?
- A. *EBITDA is a primary focus for sophisticated investors because they can, they can put it into context. To Mum and Dad investors they're more concerned with NPAT, net profit after tax –*
- Q. And the shareholders –
- A. *– they understand net profit. I'm not sure they even understand surplus but they understand net profit.*
- Q. Right. But they'd be more interested in the company that had decrease in sales and rising net profits than the other way round wouldn't they?
- A. *A mature company with a decrease in sales is a concern to anyone. So the issue that we're focusing on here is the growth in those sales.*

27.15 The repeated and confusing use of EBITDA in the prospectus does nothing to inform a notional investor and is likely to lead into error when assessing the performance of the company.

28. SIP grants and page 85 of the prospectus – 4ASOC para 66

28.1 First it is not disputed that in FY04, under FRS, SIP grants were properly recognized in operating revenue. The grants were taxable receipts from the Australian Federal Government paid in the financial year following the year

that the eligible expenditure was incurred.⁵⁷³ When IFRS was adopted by Feltex in FY06 the treatment of SIP grants changed and they were no longer recognized in operating revenue.⁵⁷⁴

- 28.2 Next it is acknowledged that the quantum of SIP grants for the prospective financial information for each of FY04 and FY05 was disclosed at page 50 of the prospectus. What was not disclosed was that the expenditure to which the grants related had occurred in the case of FY04, in FY03 and for FY05 would be incurred in FY04.
- 28.3 In respect of the SIP grants received in FY04 of \$4.7 million, \$2.4 million was a grant for capital expenditure incurred in FY03 and \$1.7 million was a non-capex or innovation grant incurred in FY03.⁵⁷⁵
- 28.4 The plaintiff's complaint is that there is no disclosure in the prospectus of:
- the contribution that SIP grants make to the net surplus (adjusted or non adjusted) on page 85;
 - Feltex's reliance on SIP grants to continue to boost revenue.
- 28.5 Feltex's reliance on SIP grants is addressed in section 26 – Tariffs and Imports. This section addresses the issues that arise out of FRS 29 and page 85 of the prospectus.
- 28.6 The evidence of Mr. Meredith regarding the materiality of SIP grants to FY04 at paragraphs 307 to 312 of his brief was unchallenged in cross- examination.
- 28.7 At paragraph 307 Mr. Meredith states:

“Based on my review of Feltex's financial statements and how the SIP grants were accounted for, these receipts are accounted for as part of operating revenues and are fully captured in net profit before tax (called operating surplus before tax at page 85 of the Prospectus)”

As he was unable to determine the tax treatment of SIP grants, he addressed the materiality of SIP grants on a before tax basis and compared the value of the SIP grants reported in the financial statements to the

573 Coleman brief para 26 & 51
 574 CB17 012185 @ 012188, CB20 014738 @ 014739
 575 CB12 08453

operating surplus before income tax.

- 28.8 At paragraph 309 Mr. Meredith analyses the extent to which Feltex relied on SIP grants in FY04. He compared the value of the SIP grants reported in the financial statements to the operating surplus before income tax as set out in Table 65, which is reproduced below:

Table 65: SIP grants as a percentage of operating surplus before income tax

	FY02 Actual	FY03 Actual	FY04 Forecast
SIP Grants	\$795,000	\$815,000	\$4,700,000
Operating surplus before income tax	(\$18,161,000)	\$5,685,000	\$8,064,000
SIP Grants as a percentage of operating surplus before income tax			58.28%

Source: Prospectus pages 85 [CB14 010675 at 10761], 96 [at 10772] and 102 [at 10778]

- 28.9 At paragraph 310 Mr. Meredith broke the FY04 results down into actual and forecast amounts as set out in Table 66, which is reproduced below:

Table 66: FY04 breakdown of actual and forecast SIP grants

	H1 FY04 Actual	H2 FY04 Implied forecast
SIP Grant	\$1,406,000	\$3,294,000
Operating surplus before income tax	\$10,566,000	(\$2,502,000)

Source: Prospectus pages 50, 85, 96 and 102. H2 FY04 calculated as the difference between full FY04 forecast amount less actual H1 FY04 amount.

- 28.10 At paragraph 311 Mr. Meredith sets out the concept of materiality which applied in 2004.⁵⁷⁶ A variation in amount which is equal to or greater than 10% of the appropriate base amount is presumed to be material.
- 28.11 He considered that the \$4.7 million of SIP grants received in forecast period FY04 was material to the operating surplus before tax, since the grants represent 58.28% of the forecast net surplus (before tax).

⁵⁷⁶

- In cross-examination at NOE 579 line 12 was quizzed about materiality
- Q Isn't materiality judged with reference to the fact that for a variety of reasons there can be minor adjustments to sales and other figures during the course of a reporting period? And therefore below a certain threshold it is not seen as worthwhile counting them as material, given that they are too negligible to factor in?
- A. *No I don't agree with that. Generally materiality is used in the accounting world when auditors are doing their assessment as to whether accounts are true and fair and so they, if they form a view that, well the accounts are wrong but they're, but they're wrong by only an amount which is not material, then they will still issue an unqualified opinion. In terms of when you have a preparation of accounts, all the preparation of accounts should be done you know, correctly. And there's, if you like, little need for the materiality concepts in preparing accounts.*

28.12 Under cross- examination by Mr. McLellan QC577, Mr. Meredith was challenged on his view that SIP grants should have been disclosed on page 85 of the prospectus. Mr Meredith's view was:

"I think you know for me the pertinent page, if I could go back, is page 85 where some effort has been made to adjust – and you can see there the "net surplus attributable to shareholders", which in the forecast June 2004 was 10.113 million and then it shows various adjustments to take the net surplus to 22.3 million. I would have thought that for consistency sake that that 4.7 million would be an item that would be picked up as well."

28.13 Mr. McLellan suggested that as disclosure of the quantum of SIP grants was made at page 50 of the prospectus and at page 86 in the Statement of Prospective Cashflows "Other income" of \$4.7 was disclosed that this was sufficient disclosure of the effect of SIP grants.

28.14 Such a proposition ignores the obligations under paragraph 5.5 (b) of FRS 29. SIP grants represent 58.28% of the forecast net surplus (before tax) for FY04 and are clearly of such:

"incidence and size, or of such nature, that their disclosure is necessary to explain the prospective financial performance of the entity."

28.15 Professor van Zijl, when pressed under cross examination⁵⁷⁸ conceded that the requirement to disclose SIP grants on page 85 was debatable but that their disclosure on page 85 was a matter for the directors.

28.16 The defendants have chosen to disclose on page 85 the bond redemption costs and to draw attention to their effect by including the second bottom line, but have chosen not to disclose SIP grants, which make up 58.28% of the forecast net surplus. One can only assume that the decision not to disclose the contribution that SIP grants makes to the net surplus (before tax) was because this would not assist in marketing the offer in the same way as the adding back of the bond redemption costs in the second bottom line would, as Carolyn Steele for Forsyth Barr recommended in her email of 7 April 2004.⁵⁷⁹

577 Meredith NOE page 949 line 25 to 950 line 9
 578 NOE page 2600 line 21 to 29
 579 CB10 07818

29. JLM's proposals to pay \$9 million dividend for FY2004

Pleadings: 9.7.4; 40.5; 73.5; 73.14; 73.15; 74.17; 74.18; 85.14; 85.15; 85.34; 85.35

29.1 The prospectus disclosed to investors a primary offer of \$50 million of new shares and that Feltex will use the funds received from the issue of shares by Feltex pursuant to the Offer to assist in funding the redemption of the bonds.⁵⁸⁰

29.2 The prospectus, at page 21, disclosed to investors that:

Feltex will use the funds received from the issue of Shares by Feltex pursuant to the Offer to assist in funding the redemption of the bonds.”

29.3 Prior to 27 April 2004, the due diligence process and drafting of the offer document had proceeded on the basis that Feltex would issue \$40 million of new shares in Feltex.⁵⁸¹

29.4 On 16 February 2004 Forsyth Barr raised the prospect of a dividend in respect of the year ended 30 June 2004. Mr Thomas recorded in an email⁵⁸² to Mr Millard on that date that it was his hope that the answer to that question would be:

“in February 2005 against a half year 31 December 2004 result.”

However the recommendation was for a “September” dividend to help with the marketing.

29.5 Mr Thomas was concerned about the prospect of a September dividend due to that being:

“a peak period for working capital build up prior to the “big months of October and November”...

29.6 Although there had been extensive discussions about dividend policy, until late April 2004 the Board had not agreed to pay a dividend for FY04.⁵⁸³ In their presentation of 22 April 2004, the JLMs lobbied for a final dividend for

⁵⁸⁰ Prospectus p 21
⁵⁸¹ Saunders NOE 2215 line 25 to line 31
⁵⁸² CB9 006539 @ 006541
⁵⁸³ CB12 008671 @ 008680 and 008750

H2 FY04 to be paid in September/October 2004 to “improve the pricing outcome...”⁵⁸⁴

- 29.7 In their presentation of 27 April 2004, the JLMs again pressed for a dividend for H2 FY04⁵⁸⁵ to increase retail demand by between \$25 and \$50 million. The JLMs recommended that the dividend be funded by increased debt.
- 29.8 A meeting was convened after a Board meeting on 27 April 2004 at which the presentation was made to the board. The meeting was between Messrs Saunders, Millard, Mangini, Kokic, Tolan and representatives of both Forsyth Barr and First NZ Capital. All defendants who were on the DDC were represented at the meeting.⁵⁸⁶ The meeting was called, or at least attended, by Forsyth Barr and First NZ Capital, who expressed concern that a dividend of \$5.5 million, as management had recommended at the Board meeting, would not attract enough retail demand.
- 29.9 According to Mr Saunders’ email of 28 April 2004 and his evidence, during this meeting⁵⁸⁷ it was agreed that Feltex would pay a dividend of \$9 million for FY04 and the primary offer would be increased from \$40 million to \$50 million of new shares to fund the dividend as the company could not borrow any further funds.⁵⁸⁸
- 29.10 The draft prospectus was amended to provide for the increase in the primary offer but no mention was made in the prospectus as to the application of funds received for this purpose.
- 29.11 Page 86 of the prospectus discloses to investors the prospective cash flows for FY 2004 to be:

Net cash inflow from operating activities		\$18,286,000
Cash outflow from purchase of fixed assets	\$8,500,000	
Cash inflow from share issue		\$50,000,000
Cash inflow from borrowing		\$15,000,000

⁵⁸⁴ CB10 007535 @ 007527
⁵⁸⁵ CB13 009668 @ 009669
⁵⁸⁶ Email Saunders to directors & others CB13 009695
⁵⁸⁷ Saunders NOE 2218 line 14 to line 19
⁵⁸⁸ CB13 009695

Cash outflow related to redeeming bonds	\$66,764,000	
Cash outflow repayment of borrowings	\$10,452,000	
Decrease in cash position		(\$2,430,000)
	\$85,716,000	\$83,286,000

- 29.12 From page 86 an investor would deduce that the company's bonds would be redeemed and debt position would be reduced by \$10.452 million from the proceeds of the float. The prospective cashflows for FY05 did not disclose any increase in borrowing. A reader of the prospectus would therefore not be able to deduce the need to either increase borrowing or to utilize funds from the primary offer to pay the proposed \$9 million dividend in FY04 in September 2004.
- 29.13 From page 85 of the prospectus, Consolidated statement of prospective movements in equity, a reader of the prospectus would be left with the impression that the dividends of \$16,806 million to be paid in FY05 are adequately provided for from the movements in equity during FY04. A reader would not therefore not be aware that the only way in which the dividend could be paid was by raising the additional \$10 million raised from the primary offer.
- 29.14 Submitted, as both Forsyth Barr and First NZ Capital lobbied the directors in anticipation of the meeting, and sought to convince Messrs Saunders and Millard to agree to Feltex paying a dividend for FY04 that the company was not in a position to do so from its own resources, for the purpose of selling more shares in the float, the JLMs were acting as a promoter of the securities.

30. Equity Incentive Plan 4 ASOC para 62

Disclosure of plan in prospectus

- 30.1 The prospectus at pages 30-31 makes the following disclosure:

Under the Offer, 113,523,100 Shares will be sold to members of the public in New Zealand, Bondholders with New Zealand addresses and institutional investors in New Zealand, Australia and potentially elsewhere. Conditional on the Offer closing, the remaining 6,476,900 Shares held by the Vendor will be acquired (directly or indirectly through associates) by Directors (except for Ms. Joan Withers) and Senior Managers of Feltex (the 'Participants') for consideration equal to the Retail Price. Such Shares are not available for application under the Offer. Accordingly the Participants and Senior Managers (or their associates) will collectively acquire a minimum of approximately 5.4% of the Shares currently held by the Vendor.

The Participants have been participating in a long term equity incentive plan (the Plan) with the Vendor. The Plan is realisable in the event of a trade sale or IPO of Feltex. Pursuant to the Plan, the Participants can receive from the Vendor proceeds which will exceed the cost of the Shares that each Participant will acquire from the Vendor.

Therefore, the Shares to be acquired by the Participants will be purchased from the acquiror's own cash resources or from the proceeds received from the realisation of the Plan, or, alternatively, the consideration for the Shares may be satisfied by conversion of rights under the Plan. The Participants will collectively acquire Shares with a value equal to approximately half of the benefit received by them, collectively, from the Plan.

- 30.2 This disclosure advises investors that the directors and senior managers will acquire 6,476,900 shares, being the residual shares held by Credit Suisse AMP (vendor and third defendant). The 6,476,900 shares are disclosed as being **sold** by the Vendor outside of the Offer.⁵⁸⁹
- 30.3 What is omitted from this disclosure is that this share 'purchase' transaction is in effect 100% funded by the sale by the third defendant to the public of Feltex shares,⁵⁹⁰ and as well further cash proceeds of \$7,734,773 (Schedule IV 4ASOC) which were distributed to the directors and to the executives were funded out of the proceeds of the offering.

⁵⁸⁹

Prospectus p 9

⁵⁹⁰

Russell BOE [36] , NOE 1063 line 23 to 1064 line 14

30.4 Further, there is reference at pages 30 and 31 of the prospectus of a number of option plans. The evidence of Mr Hall⁵⁹¹, a sophisticated investor, and of Mr Russell,⁵⁹² an expert stockbroker was the distinction between the various plans and the actual entitlements bestowed was difficult to discern (in Mr Russell's case even after several readings). It took Brian Gaynor a considerable period of time after the float to understand the disclosure and even then he misconstrued the effect.⁵⁹³

30.5 The prospectus advised investors that the 6,476,000 shares will be acquired, by the participants, for consideration equal to the Retail Price.⁵⁹⁴ The retail price is defined in the offer as being "*the lesser of the Final Price and \$1.95 per share*".⁵⁹⁵ The retail price will not be greater than \$1.95 per share.⁵⁹⁶ Further, the Prospectus again states:

*Conditional on the closing of the Offer, a minimum of 1,724,297 Shares will be acquired (directly or indirectly through associates) by the non-executive Directors (except for Ms. Joan Withers) from the Vendor for consideration equal to the Retail Price.*⁵⁹⁷

30.6 In the course of the trial counsel for the first defendants suggested that the term "consideration" was to be attributed the meaning of an accrual by the directors and management for their involvement in increasing the equity and value of Feltex. It can be noted that the increase in equity of Feltex, expressed in terms of net tangible assets, only increased from negative (\$13.9m) to negative (\$4.2m) pre float.⁵⁹⁸

30.7 The prospectus does not define the term "consideration". It is used multiple times in the prospectus in both senses of the word.⁵⁹⁹ The prospectus uses the term consideration in following way on page 130:

⁵⁹¹ Hall BOE [27] NOE 874 line 1 to 875 line 14
⁵⁹² Russell NOE 1065 line 24 to 1067; 1074 lines 1 to 5
⁵⁹³ CB20 014748; Cameron NOE 2395 line 8 to 2397 line 23. Mr Cameron was cross-examined on this newspaper article
⁵⁹⁴ Prospectus p 30
⁵⁹⁵ Prospectus p 121
⁵⁹⁶ Prospectus p 121
⁵⁹⁷ Prospectus p 59
⁵⁹⁸ See Meredith BOE [64]
⁵⁹⁹ Consideration: (1) careful thought; or (2) a payment or reward

CAN THE INVESTMENT BE ALTERED?

The full terms of the Offer are set out under the heading 'Details of the Offer' on pages 21 to 32 of this Offer Document. Neither the Vendor, Feltex, an investor nor any other person has the right to alter the consideration payable by an investor, described in the paragraph headed 'How much do I pay?' on page 121 of this Offer Document.

- 30.8 The term “consideration payable by an investor”, described in this paragraph and the paragraph headed ‘How much do I pay?’⁶⁰⁰ could only mean money paid (ie in cash or by cheque) by investors for Feltex shares. There was no other meaning that investors could have attributed to the word “consideration”.
- 30.9 Further, in the wording “consideration equal to the Retail price”⁶⁰¹, “equal” is an absolute concept and should not be used to attribute something subjective and qualitative, such as the involvement in and reward for the participants under the equity incentive scheme.
- 30.10 The prospectus at page 30 suggests that the participants will, or at least may, purchase the shares with their own cash resources, or from proceeds realised under the plan or conversion of rights under the plan. The evidence established that it was never intended by the participants that they would use their own cash resources and be on risk in any way from the date of exercise of their options. Mr Saunders email of 29 April 2004 to Mr Mangini sets out the position on behalf of the directors.⁶⁰²

It has been a reasonable expectation I believe, that the funding for the shares being taken up under the IPO would come from the payout of the options. Had this not been part of the understanding, I doubt that directors would have agreed to the arrangement in the first instance. The suggestion alluded to in the first paragraph clearly goes against the spirit of this understanding.

600 Prospectus p 121
 601 Prospectus, p 30
 602 CB13 009697

30.11 The first defendants were also made aware of the diffuse nature of the disclosure by Mr Stearne on 29 April 2004 when, after receiving feedback from investors made the following suggestions to the DDC:⁶⁰³

3. Following meetings with investors yesterday we believe consideration should be given to the extent of the disclosure in the offer document around the management shareholding and cash settlement of existing option/incentive arrangements.

>
> There seems to be a difference in the disclosure between directors and management. We understand that management are being paid out in cash and shares in respect of existing option arrangements. We should discuss the significance of the disclosure in light of comments/questions yesterday.

>
The JLMs suggest words to the effect of:

"[All/Certain] of the Directors and Senior Management will be collectively subscribing for [\$xx million/approx 4.5% of the shares on offer] from the proceeds they will receive from the Vendor from the realisation of long-term incentive compensation plans. These plans [were/are] realisable in the event of a trade sale or IPO of Feltex. The directors and management involved will be collectively reinvesting approximately half of the proceeds received from these long-term incentive plans, through either their subscriptions for shares in the Offer or the transfer of Shares to them by the Vendor outside the Offer."

30.12 The suggestion in the prospectus that participants would use their own cash resources to acquire the shares was misleading when this was never in fact intended by the participants. Further, the disclosure in the prospectus clearly stated that the shares taken up by the participants would be equal to the retail price when this was never intended and was not actually the case.

Inducement to purchase through directors taking up shares

30.13 The required number of shares to be taken up and retained for a year by directors and senior executives was a point of contention during the IPO process.⁶⁰⁴

30.14 In the proposal submitted by First NZ Capital to Mr Thomas and Mr Saunders on 19 December 2003 it stated, under key factors supporting the interest in Feltex's IPO, that investors would view management taking up shares "very positively".⁶⁰⁵

⁶⁰³ CB13 009699

⁶⁰⁴ CB9 006590

⁶⁰⁵ CB8 005783

Achievability of an IPO of Feltex

We believe that an IPO of Credit Suisse Group's entire stake is readily achievable. Market conditions are currently favourable and there has been limited IPO activity during 2003 to satisfy investor demand. We believe that an IPO of Feltex will attract widespread investor interest from New Zealand investors, including institutional and retail investors and Feltex's bondholders, and selective interest from Australian institutional investors. Key factors supporting this interest are:

- an IPO of this size would place Feltex within the NZSX50 index, and position it for likely inclusion in the NZSX40 index. Index inclusion attracts demand from index followers and increases the likelihood of widespread domestic institutional interest;
- Feltex has a well-recognised and highly regarded brand name, which is important to attract widespread retail investor interest;
- we expect the preferential entitlement to be very attractive to the bondholders and we would expect this component of the offer to be popular;
- we believe that selective investor interest will also be generated from Australian institutional investors. Certain of these have mandates encompassing offshore companies with Australian businesses and there has been increased focus on small-cap stocks over the past 12 months; and
- additionally, all investors will view a residual stake held by management very positively.

CB005783

30.15 Further on 4 February 2004, Mr Stearne and Mr Hamilton gave a presentation to a subcommittee of the Board⁶⁰⁶ which stated that it was an "Important signal for management to retain meaningful shareholdings."⁶⁰⁷

30.16 The first defendants intended that the shares taken up in the company by them and senior management would be viewed by investors as a vote of confidence in the company.

30.17 The effect of the plan was that the directors and senior management (with the exception of Peter Thomas⁶⁰⁸ and Joan Withers⁶⁰⁹):⁶¹⁰

- (a) did not actually pay for the shares out of their own cash resources; and
- (b) did not pay for the shares on listing; and
- (c) received a cash payment in addition to the shares they were allotted at a value of \$1.70 per share (after the listing).

⁶⁰⁶ Stearne BOE [22]
⁶⁰⁷ CB8 006051 @ 006060

⁶⁰⁸ Mr Thomas converted all his options into shares at an exercise price of \$0.1625 per option. He therefore paid \$85,000 for 522,940 shares, with a value immediately prior to listing of \$888,998.

⁶⁰⁹ Ms Withers was not a participant in the plan; Prospectus p 59.

⁶¹⁰ CB1 000582

- 30.18 The directors' and management's position was in contrast to that of an investor who paid for the shares out of their own cash resources. Mr Houghton had committed \$20,000 in late May 2004 and received 11,765 shares in Feltex on allotment.
- 30.19 Submitted the impression that the directors and management were taking up shares in the company because they were confident in Feltex's performance was misleading owing to the following statements made by the participants (which evidence concerns rather than confidence). Mr Magill in a memorandum to the Board, on 27 June 2003, in reference to the secured bonds prospectus stated:⁶¹¹



MEMORANDUM

TO: Peter Thomas

CC: T Saunders, C Horrock, D Hunter, M Feeney, J Kokic

FROM: S J Magill

DATE: 26 June 2003

SUBJECT: Disappointing Sales

Dear Peter

Now that my sensitive nature has gone back into hibernation and I have recovered from the shock of your disappointment and bafflement over the revenue line, particularly in view of New York, the Directors, the bank and brokers concern over the significant April, May, June growth the revenue margin and EBITDA lines, forecast in the prospectus. I detail below some enlightenment to the effort that has gone into the achievement of this disappointing revenue line.

It should not have come as a surprise the slowing of the order intake in April and May, as we provide the bank and the directors a weekly update on the key kpi's of sales, orders, product versus budget/forecast.

And further on:⁶¹²

The sales result in my opinion has been reasonable in view of the following issues:

- Due to the concern of everyone, about the significant increase in EBITDA and sales and margin growth required in the prospectus forecast. You will recall at the March Board meeting, I indicated to the Board that I had already put in place a growth incentive plan for the April/June quarter with major customers to try and protect the prospectus forecast. The surge in forward orders in March reflect this strategy.
- If this action had not been taken we would not have reached the sales we did.

⁶¹¹

CB6 004387

⁶¹²

CB6 004387 @ 004388

- 30.20 Clearly there were concerns about Feltex's future performance throughout the pre IPO period. The concern noted in Mr Magill's memorandum was with respect to Feltex's secured bonds offer projection for FY03. Mr Magill gave evidence that Feltex had experienced a very buoyant period in 2003/2004 which makes his comments about disappointing sales significant.⁶¹³ The FY04 forecast was for an uplift in sales of 5.4% and margin of 12.1% from FY03. A further uplift of 4% in sales revenue and 7.5% margin⁶¹⁴ was projected for FY05. Yet Mr Thomas, in an email to Mr Millard in December 2003, expressed concerns over the building cycle and Feltex's response to the cycle.⁶¹⁵ In addition, Feltex was aware that tariffs were to reduce by 5% from 1 January 2005 with the Australia - United States Free Trade Agreement providing a further 2% reduction which would provide challenges for the company.
- 30.21 The increase from FY03 to FY04 and again in FY05 in the face of a deteriorating market and increased competition⁶¹⁶ from Godfrey Hirst and imports ought to have given the defendants cause for concern over the achievability of the projection. The problems achieving sales expressed by Mr Magill in June 2003 were being repeated in June 2004.
- 30.22 Mr Thomas' email to the Board on 22 February 2004 "seeking to address what he thought to be some of the concerns which had been raised about the requirement to hold shares for 12 months"⁶¹⁷ should be compared with the earlier email chain he refers to in his brief.⁶¹⁸ The email at CB 9 006957 discusses the perception that it was unfair to require shares to be acquired under the equity incentive scheme to be held given that CSFB is "cashing out". The longer email chain links this issue directly to concerns about the projections of ongoing profitability (forecast or projected in the prospectus) and company performance.
- 30.2 Mr Thomas gave evidence that this email contained "pithy" comments and was "a bit tongue and cheek".⁶¹⁹ However, the plaintiff contends this email was a considered email, by a Feltex director to fellow directors, which

⁶¹³ ONOE (Magill) page 1894, lines 30-32

⁶¹⁴ CB11 007831 @ 007846 (8 April 2004 Presentation, see Tolan BOE [26])

⁶¹⁵ CB8 005377; see Thomas BOE [59]

⁶¹⁶ See projection section above

⁶¹⁷ CB 9 006957 Thomas BOE [124] and ONOE (Thomas) page 1230, line 8 – page 1232, line 9

⁶¹⁸ CB 9 006614

⁶¹⁹ NOE pages 1231 lines 1-2 , 14 and 19

provides guidance for participants who, it is evident, are concerned that the shares will decrease in value. Submitted the email speaks for itself and records a genuine concern by the participants that Feltex's shares would not be a good investment.

30.25 The disclosure in the prospectus was intended to portray that the participants were purchasing shares at the retail price from their own resources in order to represent confidence in the company's prospects and the achievability of the forecast and projection. This disclosure was misleading when Mr. Magill and senior management did not have that confidence, were unwilling to use their own money to bridge the purchase the shares⁶²⁰, did not use any of their own cash resources to purchase the shares and received a cash payment in addition to the shares they acquired. This was not the impression investors, who read the disclosure, would have garnered from the prospectus.

30.26 Further, the participants' interests were not aligned with the shareholders and they did not truly have "skin in the game". If Feltex failed to prosper they would lose the opportunity of making a profit, whereas the shareholders would lose their entire investment, which in the case of Mr Houghton, was a complete loss.

31 The May 2004 NZX Announcement – 4ASOC para 53 & 54

31.1 The pricing strategy for the IPO process was not conventional. As described by Mr. Hamilton⁶²¹, the process that was adopted by Feltex and Credit Suisse was a modified open price strategy, which FNZC had utilized successfully for the first time in 2003 for the Freightways public offer.

31.2 The strategy undertaken had different approaches to maximise retail investor demand and institutional demand. In respect of retail investor demand⁶²², the JLM's recommended and Feltex and Credit Suisse adopted the following strategies:

- targeted pre- marketing of retail brokers to create competition for broker "firm" stock and to keep the brokers short in the first round

621 Hamilton NOE at 2982 line 11 to 16 and CB8 005783 @ 005786 and CB8 005788 @ 0005791 & 005792

622 CB10 007535 @ 007546

- the expected outcome was \$120m+ of initial firm retail demand and
- \$40m+ of bookbuild retail demand
- Direct mails outs and advertising in respect of bondholders with emphasis in price and allocation preference and promoting yield.
- the expected outcome was \$145-55 million demand from bond holders
- advertising and media proofing of business to attract non-syndicate brokers and non- broker relationships and Feltex employees
- the expected outcome was minimum of \$10 million of demand

- 31.3 In respect of institutional demand,⁶²³ the JLM's recommended and Feltex and Credit Suisse adopted a sophisticated marketing strategy based in syndicate research analysis, pre- marketing to key institutions, followed by roadshows targeting institutions through one on one meetings, site visits and direct follow up. The aim was to make these investors compete for stock to maximize demand tension. The expectation was \$70+million of demand from New Zealand and Australian institutions and to obtain broad institutional investor base on the register.
- 31.4 The indicative price range was set at \$1.70 to \$1.95 prior to registration on 5 May 2004 following pre- marketing to various institutions. The JLM's recommended a lower bottom range of \$1.65 to reflect the level of institutional interest they had assessed during the premarketing stage⁶²⁴. Feltex and Credit Suisse set the bottom of the range at \$1.70, being Credit Suisse's minimum acceptable share price.⁶²⁵
- 31.5 Initial firm allocations to the JLM's of \$40million each were made on 5 May 2004. Allocations to Co-managers Macquarie and ABN Amro Craigs of \$20 million each were made on 10 May 2004.
- 31.5 Following registration on 5 May 2004, there was a 2 week open price period, during which the offer was marketed to the public and brokers on the indicative price range.

623 CB10 007535 @ 007547
 624 Paviour-Smith brief para 44
 625 Hamilton brief para 36

- 31.6 The book build commenced on 19 May 2004 and closed on 21 May 2004 with bids sought from institutions in New Zealand, Australia and internationally. Retail brokers were invited to bid for firm allocations.
- 31.7 The enhanced priority offer and the priority offer for bondholders closed on 21 May 2004. As at 21 May 2004, at \$1.70 bondholder exchange was 24,656,842 shares or \$39,982,000, leaving an underwrite obligation for the JLM's of \$20,017,700 or 11,775,118 shares.
- 31.8 Further bondholder conversions took place after 21 May 2004 through various strategies, including the sale of bonds to Mr. Hubbard, which would otherwise have been redeemed, who in turn converted utilising Leveraged Equities 626 to finance the transaction and acceptance of late applications.⁶²⁷
- 31.9 The public offer to retailers, Feltex employees and the general public closed on 21 May 2004. At \$1.70 the public offer closed at \$3,401,568 or 2,009,994 shares.⁶²⁸
- 31.10 The book closed on 21 May 2004. Bids were received into the book at \$1.70 as follows⁶²⁹:

New Zealand Institutions	4,060,000 shares	\$6,902,000
Quasi New Zealand Institutions	590,000 shares	\$1,003,000
Total New Zealand Institutional demand	4,650,000 shares	\$7,905,000.00
New Zealand firm broker bids	11,414,706 shares	\$19,405,000
New Zealand small broker bids	666,824 shares	\$1,133,601
Total New Zealand demand (excluding firm allocation to JLM and Co Managers)	21,831,530 shares	\$36,348,601

626 A Forsyth Barr subsidiary Paviour-Smith BOE para 75

627 The bond underwrite obligation was reduced to \$12,782,658 or 7,519,211 shares by 2 June 2004 by reallocation of excess retail demand. CB16 011419

628 By 2 June 2004 the public pool had increased to \$4,141,298 or 2,486,058 shares as a result of late applications. CB16 011519

629 CB15 011304 xls spreadsheet Book of Demand dated 22 May 2004 as sent to R Millard

Australian Institutions	0 shares	\$0
International Institutions (includes Hunter Hall at 16,000,000 shares)	22,960,785 shares	\$39,033,335
Total Bid into Book (excluding firm allocations of \$120 million to JLM and Co Managers)	44,792,315 shares	\$75,381,936

31.11 The table below compares actual bids into the book as at 21 May 2004 with the indicative demand and allocations assessed by the JLM's on 19 April 2004⁶³⁰

	19 April 2004	21 May 2004	
New Zealand institutional demand	\$40-60 million	\$7,905,000	13 - 19%
Australian institutions	\$20 million +	\$0	0%
International institutions	Potential interest	\$39,033,335	195%
New Zealand firm broker	\$40 million +	\$19,405,000	48%
New Zealand small broker	\$20 million (public pool)	\$1,133,601631	5.5%

31.12 On 22 May 2004 the retail price was set at the bottom of the range at \$1.70 and the announcement was made to the New Zealand Stock Exchange on 24 May 2004 (the 24 May NZX announcement). Both JLM's would have preferred a lower share price.⁶³²

31.13 In the 24 May NZX announcement Mr. Saunders is reported as saying:

630 CB10 007535 @ 007548
631 Public pool – non broker \$3,401,568 – see para 38.9 supra
632 Hamilton Brief para 46 Paviour – Smith para 50

“We’re delighted that the Feltex IPO has been so well received in the market. The level of retail investor interest in the offer has been excellent and the book build attracted good support from a range of domestic and international institutions and Primary Market Institutions.”

31.14 While it is accepted that Mr. Houghton did not see the actual 24 May NZX announcement, the announcement was influential for marketing strategy. According to Mr. Lim, at paragraph 16 of his brief:

“It is this sort of announcement that, as stockbrokers, we rely on to assist in our marketing strategy. I also considered that as the price had been set at the lower end of the indicative range the stock would be more attractive to retail investors and also because the projected gross dividend yield would be 9.6% as referred to in the NZX announcement.”

This evidence was not challenged on cross-examination.

31.15 It must be acknowledged that Feltex and Credit Suisse were not restricted by the factors set out at page 28 of the prospectus from setting the Retail Price at \$1.70 per share. Nevertheless as at 24 May 2004, it cannot be said as did Mr Saunders that:

- *the IPO has been ... well received in the market;*
- *the level of retail investor interest in the offer has been excellent;*
- *the book build attracted good support from a range of domestic and international institutions and Primary Market Institutions;*

when

- New Zealand institutional demand was between 13 and 19 % of the level of support that was expected pre-float;
- there was no support from Australian institutions;
- international support came from 4 UK hedge funds at low levels and Peter Hall of Hunter Hall who was a surprise investor and without whom the offer would not have closed;

- the level of retail demand assessed from non- syndicate brokers, including small brokers, was approximately 34% of the level of support that was expected pre-float;
- the public pool demand was 20% of the level of support that was expected pre-float.

31.16 In endorsing the 24 May NZX announcement with their firm's names, the JLM's sought and relied on the announcement to sell their own book at a time that the JLM's did not know the actual level of demand their firms had as at 21 May 2004.⁶³³ Ultimately FNZC had an overhang of approximately 6,658,904 shares or \$11,320,136⁶³⁴ and Forsyth Barr were obliged to go to extraordinary lengths to move their firm allocations⁶³⁵. Co manager Macquarie had an overhang of 4.268 million shares⁶³⁶. Both JLM's were obliged to underwrite the bond conversion to the value of \$12,782,659.⁶³⁷

F. Credit Suisse MP was a promoter

- 32.1 All of the consultative roles which the JLMs fulfilled in the IPO process, as provided for in the prospectus, were also fulfilled by Credit Suisse MP, together with Feltex. Again, these included fixing the indicative price range, the final price for the shares, determining any scaling, allocating shares to NZX firms, determining any lesser value of shares applied for and, as well, participating in the equity incentive scheme whereby the participating directors and senior managers would acquire 6,476,900 shares from it.
- 32.2 Some roles were to be fulfilled only with Feltex, not including the JLMs. These were making the offer to bond holders to participate in the Enhanced Priority Offer, the right to amend the dates for the opening and closing of the public offer or to withdraw the offer prior to 2 June 2004, the right to decline any application for shares, without giving reasons, meeting the brokerage costs and firm allocation fees of the JLMs, having the right to determine all questions relating to applications for shares, their decision being final and binding, and having the right to make the final decision as to the value of shares to be allocated to any applicant.

633 Hamilton NOE3030 line 8 to 15 Paviour-Smith NOE 3173
 634 Hamilton brief para 50
 635 CB16 011448
 636 CB16 011599
 637 CB16 011519

- 32.3 In a letter filed with the Registrar of Companies dated 22 April 2004 it was agreed between Credit Suisse MP and Credit Suisse PE (the second defendant, as the named promoter) that the public offer would involve the sale of all existing shares held by Credit Suisse MP in Feltex and confirming that Credit Suisse PE administered and directed Credit Suisse MP.⁶³⁸
- 32.4 The plaintiff asserts⁶³⁹ that no material distinction was made between the role of Credit Suisse PE, as the named promoter, and Credit Suisse MP.
- 32.5 In correspondence leading up to the IPO Mr Thomas invariably referred simply to “CSFB”, without making any distinction between Credit Suisse PE or Credit Suisse MP.⁶⁴⁰
- 32.6 In cross-examination Mr Thomas said that he had wanted it noted by the Due Diligence Committee that he was acting in his capacity as “CSFB AMP’s representative rather than as a director of Feltex”.⁶⁴¹ However, he confirmed that the Due Diligence Committee report dated 3 May 2004 recorded him as being the “vendor and promoter representative” and as “consultant to the vendor”.⁶⁴² He said that:

You can read that to say I am there as Credit Suisse First Boston’s representative.

He said to His Honour that he did not fully understand the role in the New Zealand securities system of a promoter:

Mr Rowe was there in my view far more in his capacity as representing Credit Suisse as a lawyer. I was there primarily to represent the Credit Suisse groups, on that committee.

When it was put to Mr Thomas that he was effectively representing Credit Suisse’s interests he answered:

... yes, that’s a fair comment, its Credit Suisse at that stage. I’m there representing Credit Suisse’s interests.

- 32.7 In the Directory of the prospectus Minter Ellison Rudd Watts are referred to as “Legal Advisers To The Vendor And Promoter”.

638

AF1 000024

639

4ASOC para [8.21]

640

See eg email 28.1.04 Thomas/Paviour-Smith CB8 005903

641

NOE 1508/22

642

DD1 000007 @ DD 000009

32.8 In cross-examination Mr Millard agreed that in his role as principal contact for Credit Suisse he was not giving any attention to whether he was acting normally for Credit Suisse PE or for Credit Suisse AMP unless there was a particular reason to make a distinction.⁶⁴³

32.9 Submitted that:

- (i) on the evidence Credit Suisse MP was a promoter and that no material distinction was made between it and Credit Suisse PE, as the named promoter; and
- (ii) A reader of the prospectus would have considered Credit Suisse MP to have been a body which fulfilled the role of a “*promoter*” defined as “*a person who is instrumental in the formulation of a plan or programme pursuant to which the security was offered to the public*”.

Indeed, a reader of the prospectus would have seen Credit Suisse MP as having fulfilled that role more than any way in which Credit Suisse PE did so.

32.10 The letter filed with the Registrar of Companies dated 24 April 2004 is also a contract of agency between the principal Credit Suisse MP (as the vendor) and Credit Suisse PE (as the promoter) as agent. Credit Suisse PE could not agree to sell the shares in Feltex or promote the prospectus without the consent of Credit Suisse MP.

32.11 The steps taken by Credit Suisse PE in respect of the IPO were to facilitate the sale of the shares owned by Credit Suisse MP and were within the scope of its agency contract.

32.12 The acts of Credit Suisse PE, applying the general principles of agency, can be attributed to Credit Suisse MP. As Credit Suisse PE is the acknowledged promoter, it follows that its acts on behalf of its principal can be attributed to Credit Suisse MP, thus making Credit Suisse MP a promoter by its actions.⁶⁴⁴

⁶⁴³ NOE 2672/11-17

⁶⁴⁴ *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500 (PC)

33. First NZ Capital and Forsyth Barr Ltd were promoters

- 33.1 The substantial role of the JLMs was effectively confirmed by the names given to them in the prospectus, namely that they were each “*Joint Lead Managers*” and “*Organising Participants*”. That certainly suggests they were “*instrumental in the formulation of a plan or programme pursuant to which the securities are offered to the public*”.⁶⁴⁵
- 33.2 An electronic search of the prospectus reveals that the JLMs are referred to by that term some 56 times (including in the subscription application form) and as Organising Participants some 18 times, in conjunction to the reference to them as JLMs.
- 33.3 They were each named in the Directory, which is on the inside cover of the prospectus, as would be expected.
- 33.4 Importantly, their firm names appear on the cover of the prospectus.
- 33.5 It is clear that their role in the IPO was quite different from and considerably more substantial than that of the three legal advisers named in the Directory (which is on the inside back cover of the prospectus) and the auditor (Ernst & Young) also named in the Directory. The reference in the prospectus to these other professional advisers is far more limited.⁶⁴⁶
- 33.6 Witnesses for each of the JLMs either completely or very substantially accepted that each firm respectively fulfilled or was entitled to fulfil the consultative roles referred to in the prospectus and application form, pleaded in 4ASOC. These included setting the indicative price, setting the final price, any scaling of the offer, the allocation of shares to NZX firms and any allocation of lesser shares than applied for.
- 33.7 These witnesses also confirmed that each was involved in all or at least most of the roles stipulated under the Mandate Letter dated 4 May 2004.⁶⁴⁷ Mr Mear agreed that Forsyth Barr was involved in distributing promotional material⁶⁴⁸, attending investor presentations and road shows in New Zealand,

⁶⁴⁵ Definition of a “*promoter*” in the SA s2

⁶⁴⁶ There is a reference to “*external advisers and auditors*” on p58; on p136 there is a reference to (inter alios) the “*the auditor*” and “*solicitors*” involved in the preparation of the offer document; Ernst & Young is named in the section containing the Auditor’s Report on pp77-79

⁶⁴⁷ CB14 010275

⁶⁴⁸ Mear NOE 3066/3-5

Australia and London⁶⁴⁹ and generally in respect of other matters relating to the IPO such as dividends, allocation strategy, public relations and research.

- 33.8 Mr Stearne agreed that First NZ Capital was involved in most of the roles stipulated in the Mandate Letter.
- 33.9 These witnesses also agreed that each JLM was involved in preparing sections of the prospectus. Documents put to witnesses included the receipt and provision of prospective financial information.
- 33.10 Both JLMs were represented in the due diligence process and attended all Due Diligence Committee meetings.
- 33.11 Both JLMs were indemnified under a liability sharing agreement dated 4 May 2004 by Feltex and the third defendant (Credit Suisse MP).⁶⁵⁰
- 33.12 Both JLMs took an initial substantial firm allocation of shares (\$40 million each) and underwrote any bond conversion shortfall (which resulted in both JLMs making a further allocation to the value of \$6.4 million).⁶⁵¹
- 33.13 The witnesses also agreed that they were involved in recommending, but did not clearly recall, attending a meeting to discuss the need for a dividend of \$9 million to be paid by Feltex for FY04 in order to increase demand for shares in the IPO.
- 33.14 Forsyth Barr committed a total of \$90 million of client funds to the IPO and institutional orders (in particular, Hunter Hall)⁶⁵² without which it maintained the IPO would not have closed or the issue price of the shares would have been materially or significantly lower.⁶⁵³
- 33.15 In its request for a greater share of the incentive fee payable to the JLMs, Forsyth Barr said that it had *“Provided leadership and added value in other important aspects of the transaction – Co-Manager relationships, road show, marketing/PR, research”*.⁶⁵⁴ Further, that it had *“Played a very major role in managing and leading the transaction. This was particularly the case at*

⁶⁴⁹ Mear NOE 3064/23-26 & 3065/9-12

⁶⁵⁰ CB 14 010275

⁶⁵¹ CB16 011452

⁶⁵² CB16 011450

⁶⁵³ CB16 011448 @ CB011449

⁶⁵⁴ CB16 011449

critical stages in the deal [dividends, allocation strategy, public relations, research, marketing]".⁶⁵⁵

- 33.16 Forsyth Barr emailed in excess of 3,000 bond holders recommending that they accept the Enhanced Priority Offer and contacted the top 2,000 bond holders to ensure they had received the offer.⁶⁵⁶
- 33.17 Importantly, it was the JLMs that conducted the book build process.⁶⁵⁷
- 33.18 Also importantly, the JLMs had the sole right to approve any transfer of shares acquired by the directors and senior management under the equity incentive scheme, which they were otherwise required to retain for 12 months.⁶⁵⁸
- 33.19 The plaintiff claims that the JLMs each promoted themselves to the public, in particular potential investors, to be professional and responsible firms whose advice and conduct could be relied upon⁶⁵⁹ and that they used their position as a professional and responsible firm to attract investor demand, undertake transaction management, provided by advice and leadership for the public offer and to develop investor relation programmes.⁶⁶⁰
- 33.20 In cross-examination Mr Stearne referred to the risks of First NZ Capital acting as a JLM as being largely reputational.⁶⁶¹
- 33.21 Mr Mear agreed in cross-examination that the business objective of Forsyth Barr would have considered the firm's:
- ...reputation and standing in the public and financial sectors as being highly competent, highly professional, capable of doing the job required in terms of investment banking or broking roles, very well.⁶⁶²
- 33.22 He further agreed that having Forsyth Barr involved in the offer provided it with the ability to access a broad investor base that it could put the offer to investors and that:

⁶⁵⁵ CB16 011453
⁶⁵⁶ CB16 011450
⁶⁵⁷ Prospectus pp26-28
⁶⁵⁸ Prospectus p31
⁶⁵⁹ 4ASOC [85.18] & [85.37]
⁶⁶⁰ 4ASOC [85.19] & [85.38]
⁶⁶¹ NOE 2859/10-13
⁶⁶² NOE 3069/29 - 3070/1

It may have provided some comfort to those investors, and also in terms of bringing in other brokers to the transaction, they had a relationship with us, and in that respect, yes.

The reference to “yes” was in response to the question that the brand name “*Forsyth Barr*” was likely to have influenced both clients and other members of the public in terms of their decision whether or not to invest.⁶⁶³

33.23 Mr Mear also agreed that Forsyth Barr’s consultation role under the prospectus was likely to be an influence on investors that it was a prominent and leading broking and investment banking firm (which) were to be consulted on a range of matters relative to pricing and other aspects of the IPO, as stated in the prospectus. Further, that putting the firm’s name on the cover of the prospectus was not just because it was standard industry practice but because the firm wanted it there.⁶⁶⁴

33.24 The JLMs were responsible for developing the marketing strategy for both the retail and institutional investors. As is evident from joint presentation of 19 April 2004 both JLM’s considered the principal market was the retail investor and framed their strategies towards “maximising” retail demand.⁶⁶⁵ The marketing strategy for the insitiutional investors was “targeted”. Mr Stearne,⁶⁶⁶ Mr Mear⁶⁶⁷ and Mr Paviour- Smith⁶⁶⁸ agreed that they expected a higher level of demand from retail investors than institutional.

33.25 The key marketing themes identified by the JLMs in the joint presentation of 19 April 2004⁶⁶⁹ were:

- Feltex has a long standing and successful operating history
- Operational strategies successfully implemented
- ...positioning Fetlex as a responsive service oriented manufacuterr of significant scale...
- ...excellent investment features – solid core earnings and potential earnings growth...

⁶⁶³ NOE 3071/15-24

⁶⁶⁴ NOE 3071/25-34

⁶⁶⁵ CB10 007535 @ CB 007546

⁶⁶⁶ Stearne NOE 2886/6-12

⁶⁶⁷ Mear NOE 3136/32 - 3137/10

⁶⁶⁸ Paviour-Smith NOE 3137/30 - 3138/10

⁶⁶⁹ CB10 007535 @ CB 0007553 to CB 007557

These found their way into pages 7 and 15 of the prospectus virtually unchanged.

H. RELIANCE

34. Reliance by Mr Houghton

34.1 Mr Houghton gave evidence showing substantial reliance upon the prospectus in making his investment.

I was influenced by my, our, purchasing of a Feltex carpet which I was very pleased with it. I was influence [sic] by the, what I read in the prospectus which informed me, or lead me to believe that I was investing in a good company with a good management structure. I was influenced by the potential for solid growth and, as well, I did like the fact that it was 9.6% dividend. That probably influenced me somewhat.670

34.2 He described reading a news release in the Dominion Post, recalling that the share price had been set at \$1.70, the dividend was at 9.6% and the IPO had been well received. That would have been a substantial part of his decision to invest.⁶⁷¹ There is some uncertainty as to whether an article or an advertisement was actually seen by Mr Houghton. There was an advertisement by First NZ Capital placed in the Dominion Post on Thursday, May 27 2004, which clearly stated the 9.6% yield.

34.3 Turning to the prospectus, Mr Houghton's evidence⁶⁷² was that had he been aware of representations made by Feltex in March 2003 to the Productivity Commission⁶⁷³ as to the threat to Feltex from imports of carpets, particularly in the MMF sector, and that these were such that they could threaten the economic viability of the company, could result in downsizing, plant closures, job losses and a decline in investor confidence, he would have seriously questioned his investment.

Q. What would have been the consequence if you had been aware that those statements had been made by Feltex in March 2003 to the Productivity Commission insofar as you were concerned?

670 NOE p22/10-15
 671 NOE p21/ 26 - p22/2
 672 NOE p35/1 - 19
 673 CB4 003295

- A. *I would have been, I would have seriously questioned my investment.*
- Q. *Say why please?*
- A. *Ah, looking at this document there seems to be a lot of pressure on sales that would affect the bottom line, and therefore my return.*
- Q. *What do you say about those statements in relation to your reading of the prospectus?*
- A. *I don't connect these statements with the prospectus at all.*
- Q. *Right, if you just explain what that means please?*
- A. *I mean, when I read the prospectus I came away with a totally different view than these statements give me.**674***

34.4 He was concerned **675** both at the fact that Feltex had made representations to the Productivity Commission asserting such matters, and also was concerned about the content of what was said. For example, Mr Bennett's submission on 4 June 2003 to the Productivity Commission⁶⁷⁶ describing a

*clear relationship between the growth in carpet imports and reduction in tariff rates. The key point, the further reductions and tariffs, as you proposed in your position paper, down to 5% by 2010, we submit will further negatively impact the shape of volume...**677***

would have dissuaded him.

34.5 It is clear that Mr Houghton was not aware of the difference between what Mr Magill paid for his shares pursuant to the options plan and that which he paid. That confusion extended to not understanding who was paying the balance of the purchase price. His reaction in relation to Mr Saunders, and to a lesser extent Mr Hunter, was less strong but his decision making would have been coloured. He was concerned:

*that clearly some people with more information than myself would be wanting to offload their shares so quickly, given that I was viewing it as a long term hold.**678***

674 NOE p35/1 -19
 675 BOE [58]
 676 CB6 004251 @ 004346
 677 NOE p37/25 to p38
 678 NOE p44/15 - p44/3; CB2014662; CB2014726

- 34.6 He was not aware at the time of investment that the IPO was to be increased by \$10 million, \$9 million of which was to pay an increased dividend, and would have been concerned that the dividend was coming from his own funds rather than the company 's profits.
- Q. Tell the Court why it would have influenced your decision to invest, as you've said?
- A. *Ah, my dividend should be coming from profit from the company, not from my own pocket.***679**
- 34.7 He was not aware at the time of investment that there could be a shortfall against sales forecast for the financial year of 2004 in the order of \$7.5 to \$9 million. That would have caused him serious concern.**680**
- 34.8 He understood from the prospectus that sales were increasing and that it was *"a solid growth company, which is exactly what I wanted, and growing companies increase their sales."***681** If sales were falling at the time the prospectus was issued then he would not have bought shares in that company.**682**
- 34.9 When taken to page 85 of the prospectus, and questioned about the second bottom line, he said:
- Well my natural want would be to go to the bottom, to the second line, and I'm quite confused about the description... and I'm not really sure what, I'm not sure quite how to read the difference between those two figures. Because on the one hand I'm being told there's 10 million then the next I'm being told there's 22 million...***683**
- 34.10 He was also questioned about the NPAT figures for 2002 and 2003 not being included on page 19 of the prospectus.**684** He was also concerned, when looking at a schedule prepared by Mr Gavigan in conjunction with his legal team in which the figures for those years were inserted that there was a loss of \$18.2 million that he was unaware of, and also in 2003 of \$6.8 million, and that there was a big difference between the 2004 and former year's figures.**685**

679 NOE p50/5 - p51/15; CB13 009695
 680 NOE p51/16 - p53/2
 681 NOE p/9 - 11
 682 NOE p53/22
 683 NOE p54/16 - 24
 684 NOE p57/16 - 30
 685 NOE pp55 – 58 esp p58 lns 6 – 16 & p59 ln 3

34.11 Mr Houghton's evidence was that he read the risks section of the prospectus commencing on page 125 but

my overall impression was that there were very standard risks relating to their business and I've, I don't know how many prospectuses I've read and how, What are my risks sections, but frankly they all look the same and there's always a statement about the value of your shares. There's always a statement about changing market conditions, its within the normal range of what I might expect to find in, What Are My Risks. 686

G. LOSS

35. Loss

35.1 The basic measure for an award of compensatory damages is the sum required to put the plaintiff into the position the plaintiff would have been in if the wrong had not occurred.⁶⁸⁷ In a tort claim this means the position the plaintiff was in before the tort was committed.⁶⁸⁸

35.2 The key purpose when assessing damage is to reflect the extent of the loss actually and reasonably suffered by the plaintiff.⁶⁸⁹

35.3 Where any uncertainty makes it difficult to calculate damages the court must simply do the best it can in the circumstances.⁶⁹⁰ Any rules or principles constitute guidance only. The object is to be fair to both sides.⁶⁹¹

35.4 FTA s43(3) enables the court to make an order:

- (a) declaring the contract between the parties void;
- (e) directing a party to refund money;
- (f) directing a party to pay the amount of the loss or damage.

35.5 SA s38D provides that the purpose of an investment statement is:

⁶⁸⁶ NOE p62 Ins 7-14
⁶⁸⁷ *Attorney-General v Geothermal Produce New Zealand Limited* [1987] 2 NZLR 358 (CA) at 359, 370; Todd at [25.2.01]

⁶⁸⁸ Todd at [25.2.01], citing three decisions of the Court of Appeal
⁶⁸⁹ *Marlborough District Council v Altmarloch Joint Venture Limited* [2012] 2 NZLR 726 (SC) per Tipping J at [156]; Todd at [25.2.01]

⁶⁹⁰ *Butler v Countrywide Finance Limited* [1993] 3 NZLR 623 per Hammond J at [639]; Todd at [25.2.01]

⁶⁹¹ *McElroy Milne v Commercial Electronics Ltd* [1993] 1 NZLR 39 (CA) per Cooke P at [41]; *Chase v De Groot* [1994] 1 NZLR 613 per Tipping J at [627]; Todd at [25.2.01]

To provide key information that is likely to assist a prudent but non-expert person to decide whether or not to subscribe for securities.

35.6 Also relevant in this regard is SA s34(1)(b), which provides:

- (1) *No registered prospectus shall be distributed by or on behalf of an issuer, - ...*
- (b) *If it is false or misleading in a material particular by reason of failing to refer, or give proper emphasis, to adverse circumstances (whether or not it became so misleading as a result of a change in circumstances occurring after the date of the prospectus).*

35.7 The plaintiff says that if it is accepted that he would not have invested if there had been sufficient disclosure then he is entitled to a full refund of the money paid when he subscribed for his shares, plus statutory interest. This is the equivalent to the remedy available of rescission or cancellation of the subscription contract. The plaintiff is still entitled to cancel the contract in terms of the Contractual Remedies Act s9(3)(a), (4)(a) or (b)(i) or (iii).

35.8 Alternatively, if that relief is not available then he seeks an order for an inquiry as to the loss suffered by him in terms of the difference between the assessed value that his shares would have had if the alleged misleading or untrue statements or omissions had not been made or occurred. However, it is evident that assessing the value of the shares would have had in that event would be a very difficult task, as Professor Cornell's evidence effectively demonstrates. It would also be dependent on the ways in which the prospectus was found by the Court to have made insufficient disclosure.

H. AFFIRMATIVE DEFENCES

Limitation

36.1 The first cause of action (FTA s9) is alleged by all the defendants to be statute-barred as having been brought more than three years after the date on which loss or damage ought reasonably to have been discovered by the plaintiff, in terms of FTA s43(5).

The law

36.2 FTA s43(5) provides:⁶⁹²

(5) *An application under subsection (1) may be made at any time within three years after the date on which the loss or damage, or the likelihood of loss or damage, was discovered or ought reasonably to have been discovered.*

36.3 As to what constitutes sufficient knowledge in terms of s43(5), in *Commerce Commission v Carter Holt Harvey Limited*⁶⁹³ Tipping J (for himself and three other judges) said:

[30] *... what the applicant must therefore know to set time running in respect of past loss, is that it is more probable than not that loss has occurred.*

[31] *... time should not start running when past loss is just a mere possibility or something that could well have happened. Nor should the commencement of the 3 years be deferred until past loss is a near certainty. The likelihood of past loss in the sense that it is more probable than not strikes an appropriate balance between the competing interests in legislation the principal purpose of which is consumer protection. Any lesser degree of likelihood would be apt to have time running against plaintiffs too early to be a satisfactory reflection of the statutory purpose. On this basis, in a case like the present, the question to be answered is when did the Commission become aware that it was more probable than not that a person or persons had suffered loss. As loss is not relevant for present purposes unless it was occasioned by a contravention of the Act, the words "as a result of a contravention of the act" are necessarily implicit in this question. The same concept of probability should apply, for present purposes, to the applicant's awareness that loss has been occasioned by a contravention.*

The evidence

First (and second) causes of action (FTA s9)

36.4 The plaintiff denies that the first (and second) causes of action are statute-barred. The proceeding was filed on 26 February 2008. It included a claim under the FTA. The plaintiff's position is that this cause of action did not accrue until mid-July 2007 when Mr Houghton received a copy of a generic

⁶⁹²

As at May 2004

⁶⁹³

[2010] 1 NZLR 379 (SC). All members of the court were in agreement as to the reasonable discoverability issue. Elias CJ had a differing view as to whose discovery was relevant.

letter sent to Feltex shareholders by Wakefield Associates dated 5 July 2007.⁶⁹⁴

- 36.5 Mr Wakefield said Mr Houghton did not receive the letters he sent to client shareholders on his list (ie those who had returned a signed authority and paid a required contribution for costs) dated 15 December 2006⁶⁹⁵ and 26 January 2007.⁶⁹⁶ In any event, neither of these letters disclosed that there was an available claim against the directors or promoters, only the possibility of such or of a derivative action. Mr Wakefield said in the second letter that he was going to discuss the matter with an expert accountant.
- 36.6 Mr Wakefield said that he had no other communication with Mr Houghton in 2007 (ie prior to his letter dated 5 July 2007).⁶⁹⁷
- 36.7 Mr Houghton was unaware of having received any such communication in 2007 (ie before the letter dated 5 July 2007), except as to the possibility a communication in 2007, however, the information in this regard may have come from Mr Gavigan.⁶⁹⁸
- 36.8 Counsel's memorandum dated 8 April 2014 (as to the imputation of Mr Wakefield's alleged knowledge to Mr Houghton) denied that waiver of privilege should be able to be used as a means of ascertaining what Mr Wakefield's knowledge was as Mr Houghton's solicitor and agent (which the Court had held Mr Wakefield was).
- 36.9 Counsel's memorandum further submitted that Mr Wakefield did not have a duty to inform Mr Houghton of his knowledge as to any claim under the FTA until Professor Robb's and Mr McVeigh QC's expert opinions had been obtained. Mr Wakefield's letter of 5 July 2007 confirmed that these opinions had by then been obtained. The issue of joint representative proceedings for the clients' losses, including under the FTA, was referred to.
- 36.10 Counsel's memorandum referred to *Bowstead and Reynolds on Agency*⁶⁹⁹ as to when an agent's knowledge is imputed to the principal.⁷⁰⁰

⁶⁹⁴ Houghton BOE [31]; Wakefield memorandum 27.3.14 p2, last bullet point (the memorandum)
⁶⁹⁵ Document E in the bundle to the memorandum
⁶⁹⁶ Document F in the bundle to the memorandum
⁶⁹⁷ Memorandum p3, last para; NOE 994/28 – 995/15; 999/12-15
⁶⁹⁸ NOE 1007/5 – 1008/15;
⁶⁹⁹ 19th edition/2013
⁷⁰⁰ Counsel's memorandum at [7]

- 36.11 It also referred to policy reasons which militated against this conclusion.⁷⁰¹
- 36.12 In any event, there was no sufficient evidence that Mr Wakefield in fact had the requisite knowledge prior to the receipt of Mr McVeigh's opinion dated 27 July 2007. That advice was essential for Mr Wakefield to have sufficient knowledge of a claim under the FTA.
- 36.13 Also very relevant to any obligation or duty Mr Wakefield had to report to Mr Houghton is that he did not in fact consider Mr Houghton was his client in 2007.⁷⁰² That the Court has subsequently ruled otherwise does not affect his state of mind as to any obligation or duty to report owed to Mr Houghton. Other shareholders who had not returned the form or paid the required costs contribution who were not on Mr Wakefield's list were in the same position.⁷⁰³ It was those who had paid the contribution who met the costs of the opinions from Professor Robb and Mr McVeigh QC. Mr Wakefield had no record of Mr Houghton having paid a contribution.⁷⁰⁴

Third and fourth causes of action (SA and negligence)

- 36.14 The second and third cause of actions are alleged by all defendants to be statute-barred as having being brought after the expiration of six years from the date when the cause of action accrued.
- 36.15 French J's judgment in this proceeding dated 8 June 2011⁷⁰⁵ held:

- (i) If Mr Houghton obtained his shares through a firm allocation then time started to run in the negligence claim when the loss occurred, which in that case Her Honour held was 2 June 2004.

Mr Houghton said in evidence that he believes that he sent a cheque to Forsyth Barr for his subscription for shares around 27 May 2004.⁷⁰⁶ His cheque was banked on 31 May 2004. Applications for shares from firm allocations closed on 2 June 2004;

⁷⁰¹ Counsel's memorandum at [8]
⁷⁰² NOE 987/10-14; 988/4-7; 990/31-32; 994/3-12
⁷⁰³ NOE 999/25 – 1000/12
⁷⁰⁴ NOE 1003/20-23
⁷⁰⁵ *Houghton v Saunders* [2011] PRNZ 509
⁷⁰⁶ BOE [12]

- (ii) The proceeding was filed on 26 February 2008. It included the claims under the SA and in negligence;
- (iii) So the proceeding was filed in time, as French J found.⁷⁰⁷ On appeal, the Supreme Court accepted that the limitation expiry date was 2 June 2010.⁷⁰⁸

Specific paragraphs

- 36.16 The first defendants allege that various specific paragraphs of 3ASOC (now 4ASOC), plus others insofar as they rely on these paragraphs, are statute-barred because they were first pleaded in 1ASOC, which was filed on 26 May 2010,⁷⁰⁹ and which were therefore brought after the expiration of:
- (i) three years in terms of the FTA s43(5); and
 - (ii) six years in terms of the Limitation Act 1950 s40.
- 36.17 The second – third defendants challenge most but not all of the same paragraphs as the first defendants, plus others insofar as they rely on these paragraphs.
- 36.18 The fourth defendant challenges most but not all of the same paragraphs as the first defendants, plus others insofar as they rely on these paragraphs and, as well, two additional ones relating to it.
- 36.19 The fifth defendant challenge most but not all of the same paragraphs as the first defendants, plus others insofar as they rely on these paragraphs.
- 36.20 The plaintiff denies these limitation claims, asserted as an affirmative defence.
- 36.20 In respect of the plaintiff himself, the disputed pleadings were first made when 1ASOC was filed on 26 May 2010. They were therefore filed:

⁷⁰⁷ At [123]
⁷⁰⁸ *Credit Suisse Private Equity LC v Houghton* [2014] NZSC 37 at [160] per Glazebrook J (for three judges of the Court). The minority (Elias CJ and Anderson J) dissented only in respect of the argument that the proceeding was not brought by the qualifying shareholders until they had opted in to it.

⁷⁰⁹ Due to some paragraph cross-referencing errors, a replacement SOC was filed on 16 June 2010. French J's judgment at [180] recorded that 1ASOC was filed on 26 May 2010

- (i) within three years of the time limit prescribed by the FTA s43(5), time having commenced (as alleged by the plaintiff) in that regard on or about mid-July 2007; and
- (ii) within six years of the time limit prescribed by the Limitation Act s4, time having commenced in that regard on 2 June 2004.

36.21 The plaintiff further says that, apart from the second cause of action against Mr Magill introduced by 1ASOC and also the claim in respect of the Feltex 20 May 2004 NZX announcement, none of the claims made in paragraphs relied on by the defendants would constitute new causes of action but are further particulars of existing causes of action.⁷¹⁰

36.22 The principles as to what amounts to a new cause of action, as against further particulars of an existing cause of action, are:

- (i) Whether the amendment introduces a “*new set of ideas*” different to the existing cause of action or is just an extension of part of “*the same story*” or an extension of the existing cause of action;⁷¹¹
- (ii) In *Smith v Wilkins and Davies Construction Company Limited*⁷¹² whether the new cause of action is something “*essentially different*” from that pleaded earlier:

*In other words, is it something essentially different from that which was pleaded earlier? Such a change in character may be brought about, in my view, by alterations in matters of law or of fact, or both. Alterations of fact could possibly be so vital and important as by themselves to set up a new head of claim. On the other hand, more often alterations of fact do not affect the essence of the case brought against the defendant... In each case it must, I consider, be a question of degree.*⁷¹³

In that case it was considered that the legal basis of the claim was still the same, namely the failure of the duty of an employer to take proper care for the safety of his servants and the failure to provide a safe system of work. However, the plaintiff’s attempt to introduce an allegation of breach of statutory duty was held to be a new cause of

⁷¹⁰ The second cause of action in 1ASOC (also under the FTA s9) was struck out by French J in her judgment dated 8 June 2004 at [148]

⁷¹¹ See *Donan v JW Ellis & Co Ltd* [1962] 1 QB 583 (CA) per Holroyd Pearce LJ at [590], [591] and [592] and Davies LJ at [593]

⁷¹² [1958] NZLR 958 (CA)

⁷¹³ Per McCarthy J at [961]

action, because the extent of the duty in that case was governed by the legislation rather than being left to the judgment of the jury (a claim in negligence), a defence of volenti was not available for the new cause of action and it also depended entirely on a fact which was not pleaded or even hinted at in the original statement of claim. So the amendment was considered to introduce a new cause of action,⁷¹⁴

(iii) Whether there has been a “*substantial alteration*” by the amendment to the allegations previously made;⁷¹⁵

(iv) In *Chilcott v Goss*⁷¹⁶ an amendment that alleged a loan under an implied promise and money had and received was sought to be amended to an advance for a set term and a failure to repay. It was held that this was not a fresh cause of action. Richardson J stated:⁷¹⁷

But the “gist” of the cause remains. It is not substantially different. We cannot see any prejudice to the defendant in a refocusing of what is at heart and has been throughout a claim that money advanced has not been repaid.

36.23 The “*essentially different*” test has been adopted subsequently by the Court of Appeal.⁷¹⁸ Blanchard J stated:

*A plaintiff will not be permitted, after the period of limitations has run, to set up a new case “varying so substantially” from the previous pleadings that it would involve investigation of factual or legal matters, or both, “different from what have already been raised and of which no fair warning has been given”.*⁷¹⁹

The majority (Richardson P and Blanchard J) considered that the amended claim changed the focus of the case to something not to be done just in Southland with the approval of a particular defendant for something which was not to be done anywhere in New Zealand without the approval of any

⁷¹⁴ Per McCarthy J at [963]

⁷¹⁵ See *Gabites v Australian T & G Mutual Life Assurance Society Limited* [1968] NZLR 1145 (CA) per North J at [1151]. In that case the alleged place where the accident occurred changed in the amended claim but the allegations of negligence remained the same. The amended statement of claim was therefore allowed.

⁷¹⁶ [1995] 1 NZLR 263 (CA)

⁷¹⁷ At [273]

⁷¹⁸ *Ophthalmological Society of New Zealand Incorporated v Commerce Commission* [2001] BCL 992 (CA)

⁷¹⁹ At [22] – [24]

New Zealand ophthalmologist. It was considered that this involved creating a “*new case*”.

36.24 In *Transpower New Zealand Limited v Todd Energy Limited*⁷²⁰ the principles from *Ophthalmological* were adopted. Two of the amendments sought were allowed but those that made two claims that were not pleaded at all in the earlier statement of claim were held to be a change that amounted to a fresh cause of action.

36.25 These principles would indicate, for instance, that a plaintiff is entitled to refine factual pleadings following discovery, which would not thereby constitute a new cause of action if the “*gist*” of the claim is “*essentially the same*”.

36.26 Indeed, the gist of the first, third and fourth causes of action has in fact remained the same since the original statement of claim was filed on 26 February 2008.

36.27 Finally, reference should be made to *Commerce Commission v Visy Board Pty Limited*⁷²¹ where Stevens J stated (after reviewing three New Zealand cases which considered amendments altering factual matters):

*...The theme running through all these cases is that in order for an amendment to amount to a new cause of action, there must be a change to the legal basis for the claim. That can, in theory, occur through the addition of new facts, but only if the facts added are so fundamental that they change the essence of the case against the defendant. If the basic legal claims made are the same, and they are simply backed up by the addition or substitution of a new fact, that is unlikely to amount to a new cause of action.*⁷²²

36.28 The Court accepted that the new fact to be inserted in the amended statement of claim in that case was an important one but the importance of the pleaded fact to the success of the claim was not the test. The question was whether the amendment had changed the essential nature of the claim, which the Court did not consider it had.

720 [2007] NZCA 302
 721 [2012] NZCA 383 (CA)
 722 At [146] – [147]

I. Schedule A

37. Matters admitted or acknowledged by Mr Saunders

Chairman's address at Feltex AGM 1 December 2005

37.1 In his address Mr Saunders said that a key component to the projections for the IPO was the projected volume of sales in the Australasian carpet markets in 2005.⁷²³

37.2 And that the projections were built on a consistent basis with Feltex's budgeting methodology.⁷²⁴

37.3 As to the reasons why profitability had fallen away so significantly and quickly, in his address Mr Saunders said that the second impact was that the NZ dollar was performing strongly against the Australian dollar, the prospectus assumed a cross rate of 0.8772 whereas the average rate in March was 0.9289.

Each one cent difference affects EBITDA by approximately NZ dollars 550,000 per annum.

37.4 Mr Saunders said in evidence that he did not know that it had this effect at the time the prospectus was issued,⁷²⁵ he later said that it was not something which Feltex saw as a significant factor at the time of the prospectus, but he agreed it was an important factor to tell the shareholders (at the 2005 AGM) as to one of the reasons why Feltex's reported profitability had reduced.⁷²⁶

37.5 The fourth impact was from increased import competition in the synthetic sector.⁷²⁷ Mr Saunders said in evidence that he believed that this was a contributing factor but not a driving factor.⁷²⁸

37.6 In his address Mr Saunders said that a reality in the carpet market is that the carpet industry has a fairly high break even cost structure and once you go through this break even point the margin on incremental product production is very high and flows directly to the bottom line and the reverse also

⁷²³ NOE 2095/30-35; CB20014402

⁷²⁴ NOE 2096/11-20; CB20014403

⁷²⁵ NOE 2097/24-34; CB20014405

⁷²⁶ NOE 2099/30-33 – 2100/3

⁷²⁷ NOE 2100/16-18; CB20014405

⁷²⁸ NOE 2103/1-2

applies.⁷²⁹ When asked in cross-examination whether it would have been important for people to know that this was a feature of the business, Mr Saunders said he could not recall whether it was referred to in the prospectus⁷³⁰ but thought it was implicit in the various parts of it.⁷³¹

- 37.7 Mr Saunders said in his address that one of the strategic review teams that had been appointed (as at the time of the AGM) had confirmed that New Zealand would have a significant comparative advantage over Australia and that it was internationally cost-competitive in wool yarn manufacturing. In evidence he said that this had been known for some time and it was not a total surprise.⁷³² He agreed that it was known that labour costs in particular were cheaper than Australia by quite a significant margin.⁷³³

He also said in evidence that the risk that woven carpet was under intense pressure from Asia had been known for quite some time.⁷³⁴

Interview with the Securities Commission 8 December 2006

- 37.8 In his interview Mr Saunders said that the two major factors in the profit downgrades announced by Feltex in 2005 were a very rapid market decline in Australia particularly and

*Over time there had been an erosion of our position, I wouldn't overestimate this, but there was an erosion of our position through imports, particularly into the Australian market, into the New Zealand market to an extent, but particularly to the Australian market.*⁷³⁵

- 37.9 He further said in his interview that apart from the decision to reappoint Mr Magill, there was to a lesser extent the appointment of John Kokic who it was believed would make a good Chief Operating Officer:

Quite frankly, it was a disaster and he did not do any of the restructuring which we really wanted him to do, and we had a window at that stage where we could have done quite a lot more than we did. And so as a result the restructuring which had been started in 2002/03 was really not carried on, and there were always various excuses, excuses whatever for not actually being able to carry them on. But they were so plain as to why we should have been doing

729 NOE 2103/7-14; CB20014405
 730 NOE 2103/19-20
 731 NOE 2104/12-17
 732 NOE 2106/25-31; CB20014407
 733 NOE 2106/25 – 2107/1
 734 NOE 2108/19-21; CB20014407
 735 CB20015061 (In22) – 15062 (In13)

*them, the cost structures between the two countries were incredibly disparate, we didn't want to incur the cost; always a reason.*⁷³⁶

*So there was a lot of restructuring done. Now, that should have been done much earlier. So, the Board's decisions on two top people, I think looking back, were definitely wrong and I think it hurt us very much.*⁷³⁷

*And I guess we were bringing Kovic through in the hope that he would be able to step up. I think, looking back on that now, it became – probably pretty much around the type [sic time] of the IPO actually, it became probably a forlorn hope.*⁷³⁸

37.10 When questioned Mr Saunders said it was a fair comment that the Board knew that this restructuring needed to be continued but Mr Kovic wasn't doing it and he or management were always providing a range of excuses for not doing so.⁷³⁹ Mr Saunders then said that this only became apparent much later on.⁷⁴⁰

37.11 Mr Saunders further said in his interview:

*...and actually just to emphasise, at the New Zealand end it was a strange company, old Feltex, because really we had two carpet making plants... one woven and tufting, and they were justifiable-well, woven was slightly different but became less and less competitive but that was really because of import [sic import] pressures and I guess too many – three were too many in the Australian market, three producers... so there was essentially four yarn making plants all going into a tufting plant in Foxton... Feltex got itself stuck, and other companies to an extent had to restructure, but we probably more than others... so there was an inherent uncompetitiveness in the structure of the plants over here, but they were still much more competitive than the Australian yarn making process, probably to the extent of 35 to 40%, even with the dollar up around 90 cents.*⁷⁴¹

37.12 Mr Saunders in NOE later sought to explain further what he meant by these statements.⁷⁴²

37.13 He also agreed with what Mr Thomas had said in his interview with the Securities Commission that Feltex was really managed as a series of silos, manufacturing Australia, manufacturing New Zealand, sales Australia, sales

⁷³⁶ CB21015100 (ln29) – 15101 (ln 12)

⁷³⁷ CB21015101 (lns 23-27)

⁷³⁸ NOE 2140/10-24; CB21015115 (ln 29) – 15116 (ln 2)

⁷³⁹ NOE 2132/3-7

⁷⁴⁰ NOE 2132/12

⁷⁴¹ NOE 2135/25-34; CB21015103 (ln 25) – 15104 (ln 19)

⁷⁴² NOE 2136 - 2138

New Zealand, HR, whereas for the company to be successful the communication had to be significantly more horizontal than vertical.⁷⁴³

- 37.14 He agreed with the gist of what Mr Thomas said in his interview that post the recovery (after 2001/2002) Feltex went into a strong market and that significant strength in the company hid many of the problems that were emerging in it and they weren't addressed then when they should have been while Feltex had strength in the company.⁷⁴⁴

Article in the New Zealand Herald by Rebecca Macfie (published 30 October & 6 November 2006)

- 37.15 Mr Saunders remembered an interview with Rebecca Macfie at some stage.⁷⁴⁵
- 37.16 He accepted the gist of the statement that the market in Australia, to which Feltex was now substantially more exposed (ie after the merger with Shaw) was subject to huge fluctuations which were "very quick and often unforecast".⁷⁴⁶
- 37.17 He also agreed that he may well have said that Feltex had been through two severe downturns in the previous eight years (in 1997/98 and 2001/2002) during which aggressive discounting had severely damaged its profitability. He did not dispute that he had said (to the journalist) that Feltex knew from experience that the Australian market was subject to large and often unpredictable swings.⁷⁴⁷

⁷⁴³ NOE 2141/4-25
⁷⁴⁴ NOE 2141/26 – 2142/19
⁷⁴⁵ NOE 2148/25
⁷⁴⁶ NOE 2149/26-32– 2150/7; AF1000014
⁷⁴⁷ NOE 2150/28 – 2151/7; AF000015

K. Schedule B

38. Evidence of Mr Thomas in his Securities Commission interview

38.1 In his interview on 8 December 2006 with the Securities Commission,⁷⁴⁸ Mr Thomas was cross-examined about his statement that the first issue as to the factors that lead to the failure of Feltex would have been:

The culture of Shaw and the culture of Feltex, significantly different cultures, and that goes back to the merger of the two companies. While it's gonna sound critical of the past, I don't think that previous senior management did a great job of trying to integrate this into one company. The "we" and "they" attitude across the Tasman was quite pronounced.... The company was really managed, I think, as a series of silos; Manufacturing Australia, Manufacturing New Zealand, Sales New Zealand, Sales Australia, HR New Zealand, HR Australia, whereas for this company to be successful ... the communication had to be significantly more horizontal than vertical.⁷⁴⁹

38.2 Mr Thomas said that this was an issue over time but that there was more in it when he became chief executive officer (which was in August 2005):

But definitely there was some "we" and "they" continuing.⁷⁵⁰

38.3 He again said that his reference to the company being managed in a series of silos became more apparent when he got in as chief executive officer,⁷⁵¹ although he accepted that prior to this at times he thought the company should speak better amongst its operations and that this wasn't something that had never passed his attention.⁷⁵² Thomas later made further reference to this becoming more apparent to him in 2005.⁷⁵³

38.4 As to what he said that following the recovery (from 2001/2002) there was significant strength in the company that hid many of the problems that were emerging in it and that these weren't addressed then when they should have been,⁷⁵⁴ Mr Thomas said that these problems that were evident were not emerging until 2005.⁷⁵⁵

⁷⁴⁸ CB20 015006
⁷⁴⁹ CB20 015040/30 – 005041/13
⁷⁵⁰ NOE 1379/10-20
⁷⁵¹ NOE 1380/1-12
⁷⁵² NOE 1380/1-14
⁷⁵³ NOE 1381/9-17
⁷⁵⁴ CB20 015041
⁷⁵⁵ NOE 1382/30-33