COMMENT ON EXPERT REPORTS

By Leigh Warnick*

Not so long ago, the subject of experts' reports was a fascinating one. Some of us collected experts' reports as a hobby, and I can tell you that the people who loved this hobby most were lawyers who specialised in corporate litigation. In a contested takeover, for example, the first thing you would look for would be a nice juicy expert's report. The rule of thumb was that in seven out of ten transactions, if you scratched the surface of an expert's report, you would find something festering underneath — just what you wanted to get a challenge to the transaction off the ground, and with luck enough to get you up at the interlocutory stage. And as we all know, if you can get up at the interlocutory stage, the chances of negotiating a favourable settlement before a full trial are very high.

But in the last year or so, the fun has gone out of experts' reports. Why? Two reasons: the *Pivot* case, and a new and tougher NCSC policy on licensing.

Those are the two things that have spoiled our fun, especially the *Pivot* case. I will say more about them in a moment. But first, let us focus for a minute on this question of what an independent expert is supposed to be. There is a definition in s. 5(1) of the Companies Code:

> 'expert', in relation to a matter, means any person whose professional reputation gives authority to a statement made by him in relation to that matter;

By virtue of ss. 4 and 7 of the Companies (Acquisition of Shares) (Application of Laws) Act 1982 as enacted by each of the States, that definition also applies to the Companies (Acquisition of Shares) Code. But this definition leaves out a significant factor — an expert has to know what he is talking about. Contrast the Macquarie Dictionary definition:

> a person who has special skill or knowledge in some particular field.

This distinction between someone whose profession or reputation means he *should* know what he is talking about, and someone who actually *does* know what he is talking about, is very significant as we will see.

Now, an independent expert only needs two attributes: independence, and expertise. It does not seem much to ask. But our experience in Australia over the last eight or more years, since the Co-operative Scheme legislation brought in most of these requirements for experts' reports, has been that the general standard of experts' reports have been very low. What the Court said recently in the *Pivot* case about experts' reports in general, and about a report prepared by one of the (former) big eight accounting firms in particular, warrants quotation at length:

> Those who prepare experts' reports in company cases carry a heavy moral responsibility, whatever their legal duties may be. These reports are either required by the Codes or provided by analogy with these requirements. In either case, they are supposed to be for the protection of individuals who are being invited to enter into some kind of transaction.

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> Unless high standards are observed by those who prepared these reports, there is a danger that systems established for the protection of the investing public will, in fact, operate to their detriment through reliance placed on these reports and on the reputations of those who furnish them. In lending his name, the expert will often, as in this case, be lending a name to conjure with.
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> These reports will often be on questions about which an expert could prepare a tolerably plausible report either for or against. The expert will often have a great name, great experience and great ability (I do not say desire) to support either one conclusion or the other. The stakes, and the fees, are often high and the protagonists pressing. The expert's integrity and freedom from baneful influences are essential.
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> It is impossible so lay down specific rules dealing with communications between the expert, on the one hand, and the company and those representing it, on the other: everything depends on the circumstances. The guiding principle must be that care should be taken to avoid any communication which may undermine, or appear to undermine, the independence of the expert. What happened here was quite unsatisfactory . . . I think the present case should serve as a model of what ought not to be done. The sooner experts and their clients realise this, the better. The interests of Pivot's shareholders would have been better served if, instead of their money being spent on the procuring of the Arthur Andersen report, that report had never been placed before them.[1]

CRITICISM OF EXPERTS — THE PIVOT CASE

The *Pivot* case is a graphic illustration of the standards of expert reporting that prevailed in the 1980s, and the pressing need to do something about them. It is like the old, old story that can never be told too often; every securities industry professional should be made to read it at least once a year.

The main lessons from the *Pivot* case are:

(1) The accountants acting as experts should have been appointed by the company, not recommended by its merchant bankers as part of their advice on strategy and tactics.

(2) The merchant bankers should not have sounded out the accountants on their likely approach before appointing them as experts.

(3) The accountants should not have started drafting their report before they were given a proper written proposal to comment on. Otherwise there was an obvious danger that the proposal and the report could be manipulated to fit in with each other — which so the Court found was exactly what happened.

(4) The 'expert' accountants should not have got involved in meetings between the company and its team of advisers. Independent experts are supposed to be objective, and they should keep out of discussions about how the proposals they are evaluating can best capture shareholders' support. The danger is that the expert comes to see himself as part of the team and gets caught up in the desire to make the proposal succeed. What is more, by going along and giving a presentation on his intended approach before the appointment was made, the expert gave the company the chance to see if he would give them the result they wanted. In his evidence, the accountant said he thought this was normal — and so it is. But be warned: the judge said this kind of 'expert shopping' compromises the expert's independence and is quite unacceptable.

1 *Phosphate Co-operative Co. of Australia Ltd* v. *Shears* [1989] VR 665, 683 per Brooking J.

(5) The accountants should not have sent their draft report to the merchant bankers for comment. They were supposed to give the bankers their opinion. This went on repeatedly, over a number of drafts — even to the point where the company's advisers and lawyers were writing part of the expert's report for him. The judge said:

> It is an exaggeration, but only a slight one, to say that . . . Pivot and its advisers are there to report on the independent expert's proposal, instead of the independent experts being engaged to report on Pivot's proposal.[2]

(6) The accountants should not have let the company talk them out of doing a valuation as part of their report. Later, the accountants made matters worse by using language which implied that a valuation had been done.

(7) The judge was particularly upset with the action of the accountants in preparing a final report, then suppressing it and producing another discussion draft under pressure from the company. He said

> It is bad enough to do what was done here by Arthur Andersen, when it accommodated its client by repeatedly settling draft reports in consultation with the client and its advisers. It makes matters worse to then tacitly agree to the suppression of a supposedly final report and its replacement by a different document and to go on to destroy the firm's copy of the supposedly final report, in order to prevent comparison with its successor.[3]

The judge had several more complaints; his final verdict was this:

> On the whole of the material, I am not satisfied that the report of Arthur Andersen, dated 31 March, contained a genuine expression of opinion in discussing whether the scheme was in the best interests of members. Indeed, notwithstanding the gravity of the matter, I find affirmatively that the report did not express an opinion genuinely held in discussing that question but was the result of an exercise carried out for the purpose of arriving at a desired result.[4]

In the notice of meeting, the directors of Pivot had put a lot of emphasis on the Arthur Andersen report. The judge concluded that the directors deliberately set out to keep the price down, and put pressure on Arthur Andersen to give the report they wanted. The pressure was successful, but the exercise was a failure in the end because the judge said the shareholders were misled, and he refused to approve the scheme of arrangement.

The *Pivot* case is not an isolated example. In February 1989, an article was published which recounted the observations of the Melbourne consultant, Investment and Business Research Ltd (IBR), which monitors and grades all independent experts' reports issued in Australia. It warned that:

> Accountants need to lift their game . . . Some of the weakest section 23 and 12(g) reports are coming from the 'Big 8' firms. . . Too often we find that a firm is let down by its West Australian or Queensland branch. It's hard to believe people who have been partners for 16 years could produce such poor quality documents.[5]

2 Ibid. 680.
3 Ibid. 682–683.
4 Ibid. 868.
5 L. English, 'Experts' Reports under Fire' (1989) 51 (1) *Australian Accountant* 47.

The IBR people came to the same conclusion as I have. So-called 'independent experts' in Australia all too often suffer from two problems: they are not experts, and they are not independent.

As to the lack of expertise, accountants in particular often fail to perceive that writing a report on a securities transaction requires more than pure accounting skill. It's really quite a different kind of expertise. At the heart of it is the valuation of shares, which is in itself a specialist field of considerable intellectual difficulty. An accountant who has no prior experience in the valuation of shares in listed public companies is highly unlikely to be able to write a meaningful report to shareholders on the merits of an offer for their shares, whatever his qualifications and experience in other areas of accounting may be.

But lack of expertise is not the biggest problem. The biggest problem is lack of independence, which leads to the worst sin an expert can commit: starting with the conclusion the client wants to reach, and working back. This, said the judge, was what happened in the *Pivot* case. I have seen it happen in so many other expert reports over the last few years, that it is worth taking a moment to ask ourselves why.

Professionals like accountants, merchant bankers, stockbrokers, consulting geologists and even lawyers are basically fee-driven. They need to earn fee income to survive. Their business is all about establishing relationships with clients, working closely with clients — giving clients the service they want. I call this the 'marketing impulse'.

But when the same person becomes an independent expert, he or she has to put aside the marketing impulse. The independent expert must forget about giving the client what it wants and concentrate on giving the client the product of his or her independent, professional judgment — which may be exactly what the client does not want. Basically, what we have here is an inherent conflict of interest: the expert is being paid by someone (the company), but his or her duties are owed principally to someone else (the recipients of the report — usually the shareholders).

In these circumstances, it is all to easy for the ingrained marketing impulse to override the unfamiliar concept of independent objectivity, so that the professional reverts to the familiar role of giving the client what it wants. The expert finds out what the client wants in the report, and works back. It is only natural, and it is all too common — but it is terribly dangerous, and professional practitioners who want to do this work need to learn to fight back the marketing impulse and apply their expertise in a totally objective and independent way.

THE ROLE OF THE NCSC

After the *Pivot* case, two things were clear:

- there needed to be higher standards of competence and independence imposed on people who wrote expert reports on securities transactions; and
- the confusion about whether accountants and other professionals not engaged full-time in the securities industry needed an investment adviser's licence to give advice on securities had to be resolved.

The National Companies and Securities Commission ('NCSC') recognised these problems, and decided to do something about them. The first step in the NCSC's program of action was the release on 30 June 1989, of a revised version of Release 333. This is the NCSC Practice Note dealing with licensing of players in the securities industry. In a nutshell, Release 333 is intended to tell people when they need a licence, and what their obligations are if they have one.

At the time this Commentary was prepared, Release 333 was undergoing a further revision. Care should be taken to refer to the current version. As far as expert reports are concerned, the main points made by the June 1989 version of the Release are:

(i) The difference between 'advising' and 'dealing' is clarified (paragraphs 16 and 17). This is important for accountants because as we have seen, an accountant does not need a licence if he gives *advice* to clients, in a way that is solely incidental to his accounting practice; but if he *deals* in securities, he needs a licence whether or not the activity is incidental to his accounting practice. Briefly, the NCSC's view is that:
   — an accountant is 'advising' when he stands to make no financial gain from the transaction, other than a fee paid by the client; but
   — an accountant is 'dealing' where he stands to receive any other financial benefit, usually from the issuer or provider of the securities — even a free trip or research advice at discounted rates.

(ii) The NCSC's view on the meaning of 'solely incidental' is set out in para. 21. The view expressed is significantly different from the earlier version of Release 333 — it has become much stricter. The NCSC now says that an accountant (or a solicitor) will only be able to give advice on securities without a licence if the advice follows on from some other advice given in the ordinary course of the accounting practice. The paragraph concludes:

   'It follows that solicitors and accountants are not permitted to provide investment advisory services as a discrete service unless an adviser's licence is held'.

   This is a clear signal that the laissez-faire days are over: from now on, accountants who give advice on securities should consider themselves well and truly within the licensing provisions of the Securities Industry Code. They must either get a licence, or curtail their activities.

(iii) Finally, the NCSC makes a clear statement in para. 18 that anyone who carries on a business of giving expert reports concerning securities must hold a licence. The NCSC has hinted in the past that the licensing provision of the Securities Industry Code might be applied to 'experts'; but now it has made a clear policy statement to that effect. From now on, accountants will not be able to write expert reports unless they hold an investment adviser's licence under the Securities Industry Code. A distinction has to be drawn here between experts' reports which relate to securities, and those which do not. Generally speaking, the rule is that if a report has to

express an opinion on the value of securities, the author needs a licence. It follows, for example, that:

- a licence will be needed for reports under s.12(g), s. 23, s. 32 or s. 43 of CASA, or the new s. 133KE in the buy-back provisions of the Companies Code; but
- a licence will not generally be needed for an investigating accountant's report on the issuer's or acquirer's accounts, under the prospectus or takeover provisions.

NCSC Policy Statements and Practice Notes do not have the force of law. They do, however, indicate how the NCSC intends to administer the legislation. They also deserve respect as statements of a view on the law, because they are based on detailed analysis of the law and considerable practical experience.

COOPERATIVE SCHEME LEGISLATION AMENDMENT ACT 1989 — REINFORCING THE LAW ON LICENSING OF EXPERTS

The NCSC's view that the authors of expert reports are caught by the licensing provisions, as expressed in the revised Release 333, was based on the existing law. However, since Part 8 of the Cooperative Scheme Legislation Amendment Act 1989 (Cth) came into force on 1 November 1989, the legal position has been even clearer.

The amending Act, via the relevant State application legislation, introduced to the Securities Industry Code a new definition of 'investment advice business', specifically extending the licensing requirement to any person who carries on 'a business in the course of which the person publishes securities reports'. A 'securities report' is defined simply as 'an analysis or report about securities'.

Since this amendment took efect, there has been no realistic chance of challenging the NCSC's view that experts reporting on securities transactions need an investment adviser's licence.

The new licensing provisions will reappear in Part 7.3 of the Corporations Act when it comes into force. Although policy on licensing is somewhat ambivalent these days and some deregulatory steps have been taken, it seems that the NCSC, and the Australian Securities Commission (ASC) as its successor, do intend to continue to use licensing as their principal weapon in the battle to lift the standard of experts' reports.

HOW TO GET A LICENCE

The criteria to be taken into account by the NCSC in assessing an application for a licence are set out in ss. 48 and 48A of the Securities Industry Code.[6] Applicants who are individuals must be of good fame and character, have adequate qualifications and experience and have nothing in his or her background that gives the Commission reason to believe the licensee will not perform his or her duties as a licensee efficiently, honestly and fairly. Applicants must also be solvent, and have no convictions involving fraud or dishonesty in the past 10 years. In the case of corporate applicants, similar criteria are applied to the responsible officers.

6 See also Corporations Act 1989 (Cth), ss. 783 and 784.

In practical terms, the most important criteria for getting a licence boil down to two: qualifications and experience. For qualified accountants, qualifications will not be a problem, because their accounting qualifications will be sufficient. Experience, however, may present greater difficulty. For merchant bankers, the problem may be the other way around: some of them are proud of their experience, but not too sure of their qualifications! This brings out the fundamental point which I made earlier: advising on the value of securities is a specialist field of its own, and experience as an accountant, merchant banker (whatever that may mean) or even stockbroker does not necessarily qualify a person to advise in this specialist area. To be licensed either to advise clients or to write expert reports, professionals will need to be able to demonstrate that they have relevant experience in assessing the value of securities.

This, I venture to suggest, is one of the areas where the application of licensing provisions to accountants, in particular, will have its greatest effect. It is likely that the requirement for relevant experience will be strictly enforced, and that a number of practitioners who wish to enter this field simply will not be able to do so until they can demonstrate experience in it. This, in my view, is a good thing.

HOW TO KEEP A LICENCE

The NCSC's objective in applying the licensing provisions to accountants or other professionals who involve themselves in securities transactions is to force up the standards of professional performance. Restricting entry to experienced people is one way to do that; but it is not enough. It has to be accompanied by active administration of the licensing provisions, so that people are forced to maintain reasonable standards of performance if they want to keep their licences.

The duties of licensees are dealt with in paras 5 to 13 of Release 333. Apart from observing any conditions imposed on the licence, the general provisions of securities law and fiduciary obligations to clients, a licensee's principal duty is to act 'efficiently, honestly and fairly' in performing his duties. If the Commission has reason to believe that the licensee has not acted efficiently, honestly and fairly, it can revoke the licence, provided the licensee has first been given a hearing.

The meaning of 'efficiently, honestly and fairly' was considered by Young J. in *Story v. NCSC.*[7] His Honour began by saying that the test was 'obviously designed to protect the public'.[8] He went on to analyse the specific words used in the Code:

> ... 'efficiently, honestly and fairly' must be read as a compendious indication meaning a person who goes about their duties efficiently having regard to the dictates of honesty and fairness, honestly having regard to the dictates of efficiency and fairness, and fairly having regard to the dictates of efficiency and honesty.
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> ...
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> So far as 'efficient' is concerned, someone is an efficient person or performs his duties efficiently if he is adequate in performance, produces the desired effect, is capable, competent and adequate ...[9]

7 (1988) 13 NSWLR 661.
8 Ibid. 672.
9 Ibid.

The long and short of all this is that the NCSC has power to take away the licence of a person who advises clients on securities, or who writes expert reports on securities transactions, if it has reason to believe the person has not maintained reasonable standards of competence, honesty and ethics.

The most interesting issue raised by all of this is likely to be how the NCSC and ASC eventually apply the standards of efficiency, honesty and fairness to experts' reports. How bad will an expert's report have to be before the expert loses his licence?

As I have said, the general standard of independent expert reporting over the last few years has been very low. Stopping practitioners without specialist experience from writing them is part of the answer, but only part: we have seen that lack of independence is at least as big a problem as lack of expertise. If the NCSC and the ASC do take a tough stance on licensing of experts, it may soon lead them into conflict with accounting firms and merchant banks: not only over the standard of analysis in their reports, but also over the issue of independence.

Independence has two aspects: *initial* independence, in the sense of being free from any influence which may be exerted by the client at the time of selection, and *continuing* independence, which means remaining independent and objective throughout the report-writing process and resisting any attempt by the client to influence the expert's professional judgment. Both of these are areas where experts have fallen down in the past. If the NCSC's campaign to lift expert reporting standards is to succeed, it will have to be serious about revoking or suspending the licences of those 'experts' who fail to understand what independence means. The standards of independence expected by the NCSC are now set out in Release 351 — the next step in the NCSC's campaign to tell the industry what is expected of it, and make sure it complies.

THE FUTURE FOR INDEPENDENT EXPERTS

Of course, securities industry professionals should not need an NCSC release to tell them what independence and expertise mean. The threat to their reputation from writing a bad report, and the very real threat of being sued for negligence, should be enough to focus their minds on proper professional standards. But experience shows this has not been the case: so people who want to act as experts will now have to first get a licence, then make sure they do not lose it.

Both the NCSC and ASC are going to need dedication and commitment to make this policy stick. Measuring independence and expertise against the statutory standards of efficiency, honesty and expertise is a highly subjective exercise, and with reputation and income at stake professionals who are threatened with the loss of their licence are likely to fight these issues through the courts as far as they can go.

I hope the NCSC and ASC will be successful. If it is, what we can expect to see — and I think we are already seeing — is the emergence of a sub-group within the accounting, merchant banking and broking profession (a relatively small group of licensed individuals — mostly, I would expect, from merchant banks and the 'big six' accounting firms) who

specialise in giving advice on securities transactions and writing expert reports. Licences under the Securities Industry Code will be the equivalent of a practising certificate for these people, and they will need to give real priority to maintaining standards of independence and expertise so that their licences are not taken away. This is likely to mean this source of fee income will be lost to smaller accounting practitioners. However, this is the price the profession will have to pay for its failure to achieve acceptable standards of expert reporting in the past. My own view is that if it can lift standards of expert reporting, the NCSC and its successor will have struck a very significant blow for the long-suffering cannon fodder of the Australian securities industry — the ordinary shareholder. Not that ordinary shareholders ever read experts' reports; we all know they do not. But analysts do, and the Stock Exchange does. Above all, most companies will not have the audacity to proceed with a transaction unless they can find an expert to say it is fair and reasonable.

Deals live or die by the independent expert's report; that is why experts are placed under such enormous pressure to bend their professional standards to give the right result. What we need is some form of countervailing pressure. The maintenance of professional standards has to become a matter of life or death — at least in a professional sense — for the expert. The theory behind licensing of experts is that the threat of losing the licence will have this effect.

Since the *Pivot* case, the world has been dull for collectors of independent experts' reports. The industry is still in shock, and conservatism rules. But old habits die hard. The concept of an independent expert is a fine ideal, but can service-oriented professionals consistently achieve it? Only time will tell.