

Recent securities caselaw: De Alwis v Luvit Foods International

Introduction

The recent decision of *De Alwis v Luvit Foods*¹ by Justice Courtney in the High Court alerts directors to the severity of the liability they may face when raising capital from the public without fully complying with the “offer to the public” provisions of the Securities Act 1978 (Securities Act).

Luvit Foods International (Luvit) (the first defendant) had a sole director and shareholder, Mr Chean (the second defendant). The seven plaintiffs involved in the proceedings had invested a total of \$1.68m in Luvit over the course of a year. They had relied on oral statements made by Mr Chean and on an information memorandum detailing Luvit’s historical and prospective financial performance and plans for development.

The plaintiffs were successful in their claims under the Fair Trading Act 1986 (sections 9, 13 and 15 – 18) and the Securities Act 1978 (section 37(6)) and Luvit and Mr Chean were held to be jointly and severally liable to repay the investment monies to the plaintiffs.

Fair Trading Act claims

The Fair Trading Act claims were based on Luvit’s – and Mr Chean’s – misleading and deceptive conduct, false or misleading representations and unfair practices.

There was no doubt that Mr

Chean made misrepresentations on behalf of Luvit. However, the plaintiffs were also seeking judgment against Mr Chean himself on the grounds that he had made the claims in his personal capacity and was not merely a conduit for Luvit.

In his discussions with the various plaintiffs, Mr Chean had stressed his personal involvement in the business, his personal ownership of the patents and had made statements “*well beyond merely passing on information on behalf of the company*”. The Court held that he had “*encouraged [the plaintiffs] to rely on him at a personal level*” and as such had assumed “*personal responsibility for any misleading and deceptive conduct*”.

The representations included statements as to profit over the past few years and profit projections, statements that there were no outstanding creditors and that the capital sought would be used for expansion of business in New Zealand and overseas.

In reality, the company’s “*true position was ... substantially different from that represented*”. The Court found that the representation of the current financial situation was untrue and that there was no reasonable basis for the profit projections – in fact, rather than making a profit, Luvit had been in a loss-making position for several years and the level of the projection was “*simply unrealistic*”. Rather than the raised capital being used for national and international expansion as claimed, it was used

for other purposes such as Luvit repaying a shareholder loan and to cover ongoing losses. The representations amounted to misleading and deceptive conduct and caused a loss to the plaintiffs.

Securities Act claims

The plaintiffs also brought claims under s 37(6) of the Securities Act, namely that the offer was made without a registered prospectus, and that in its absence the allotment of securities was void and of no effect.

The Court examined the ‘close business associates’ exception test discussed in the 1995 decision of *Kiwi Co-operative Dairies Limited*.² The exception requires that investors be “*sufficiently closely connected on a personal basis with the issuer*” so as to have “*sufficient relevant knowledge ... or the means of readily obtaining that knowledge*” in relation to the affairs of the business. The plaintiffs did not enjoy this proximity with the defendants and did not even know Luvit or Mr Chean prior to the initial investment. The parties were not in a close personal relationship and had had no other business dealings prior to 1999. The connection between the parties was “*well short of that required by s 3(2)*” and, as such, Mr Chean should have complied with section 33 and registered a prospectus in connection with the offer.

As the offer of securities was an offer to the public, Mr Chean’s failure to register a prospectus rendered the allotments invalid and

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¹ *De Alwis & Ors v Luvit Foods International Limited* (HC) CIV 2002-404-1944 (23 May 2007)

² *Securities Commission v Kiwi Co-operative Dairies Limited* [1995] 3 NZLR 26 (Court of Appeal).

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of no effect under section 37 of the Securities Act. The plaintiffs were thus entitled to have their investment monies repaid by Mr Chean.

Conclusion

When raising capital, whether from the public generally or just a small number of people, directors must carefully consider the nature of any offer of securities and those to whom it is to be made.

Failure to comply with the Securities Act (where it applies) and the Fair Trading Act will have serious consequences for both the company and the directors: in particular, directors should realise that the exceptions in section 3(2) of the Securities Act (e.g., for offers to close business associates and habitual investors) are not as broad as some might think.

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