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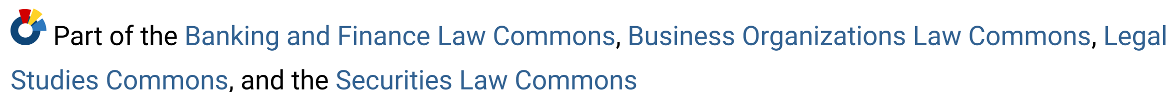
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SECURITIES UNDERWRITERS IN PUBLIC CAPITAL MARKETS: THE EXISTENCE, PARAMETERS AND CONSEQUENCES OF THE FIDUCIARY OBLIGATION TO AVOID CONFLICTS

ANDREW F. TUCH*

This article considers whether an investment bank, when acting as underwriter of a public securities offering, owes the issuing company the fiduciary obligation to avoid conflicts of interest. The question under Anglo-Australian law has not previously received judicial, scholarly or regulatory attention. The highly lucrative and visible nature of underwriting work creates powerful incentives for investment banks to accept instructions in the face of this duty. At the same time, the web of loyalties that these institutions owe, by virtue of their broad and diverse range of products and services, creates intractable practical difficulties for compliance with the duty. The article considers the factual nature of the relationship between a securities underwriter and an issuing company, the circumstances in which fiduciary obligations will exist outside the established fiduciary categories, and the existence, content and scope of any fiduciary obligation to avoid conflicts that arises. It also examines the practical and regulatory consequences for firms of the existence of this obligation.

A. Introduction

A primary reason for the company's dominance as a form of business organisation is its capacity to facilitate the accumulation of large amounts of capital from public markets on a scale not otherwise available to business.[1] However, raising capital via the issue and distribution of corporate securities to the investing public requires unique expertise, judgement and facilities—attributes which companies rarely possess. The role performed by investment banks, known as securities underwriting, is central to the capital raising process

* Lecturer, Faculty of Law, The University of Sydney. This paper was delivered at the Australasian Law Teachers Association Conference in Melbourne, Australia in July 2006. My thanks to Mila Cerecina, Emma Dunlop and Jo Pagan for research assistance. I also thank the following people for providing comments or valuable insights on earlier drafts: Gino Dal Pont, Deborah DeMott, John Glover, Ross Grantham, Jennifer Hill, Richard Nolan, Michael Tuch and Peter Watts. Thanks also are due to members of investment banks and law firms, including Greg Golding and Tony Damian, for assistance with some of the practical issues raised in the paper. Any errors are my own.

1 See, eg RC Clark, *Corporate Law* (Boston, MA, Little, Brown, 1986), ch 1.

and is the hallmark of investment banking.[2] By providing companies with financial advisory, marketing, distribution and other services (for a fee), investment banks facilitate the public distribution of securities and thus the accumulation of capital. So important is this function that a company wishing to raise capital publicly will almost invariably have the offering underwritten.[3] At the same time, the fiduciary character of the relationship between underwriters and the issuing company under Anglo-Australian law has not been questioned—a surprising gap in the otherwise highly elaborate and detailed legal and regulatory regimes in both countries. This article focuses on the initial public offering (IPO)—the first issuance of a company's shares to public investors—and considers whether in that context the relationship between an underwriter and an issuer is fiduciary in character, such that the duty to avoid conflicts of interest arises.

At law there is no standard relationship between an investment bank and issuer in an IPO. However, a standardised practice for raising capital in this way has developed, with the result that the underwriter–client relationship is well established and stable enough across transactions to be described with sufficient precision to enable an informed assessment of its fiduciary character. A distinctive feature of the underwriter's work, which reflects the investment bank's superior business acumen, deep capital markets experience and traditional role as close confidant, is the provision of financial advice. This article considers the fiduciary question by describing the relationship in question, identifying within it particular features that courts have endorsed as indicative of fiduciary character, giving emphasis to the "reasonable expectations" of the issuer in this context, and reasoning analogically from a core of cases and established fiduciary relationships. This article asserts that it is the financial advisory dimension of the relationship that is key to the existence of fiduciary obligations.

The modern investment bank is a financial services conglomerate that provides a broad and diverse range of products and services, including providing corporate advisory services (such as advice on merger and acquisition transactions), securities underwriting (including IPOs) and trading (such as proprietary trading for the firm's own account and retail brokerage).[4] As firms will act as principal or agent (or both) and owe loyalties to numerous parties, conflicts of interest are an inescapable feature of business.[5] Firms commonly

[2] See C Geisst, *Investment Banking in the Financial System* (Englewood Cliffs, NJ, Prentice Hall, 1995), 3.

[3] G Morse et al (eds), *Palmer's Company Law* (London, Sweet & Maxwell, 25th edn, loose-leaf, 1992), [5.131].

[4] See Geisst, *supra* n 2, 2; A Tuch, "Investment Banks as Fiduciaries: Implications for Conflicts of Interest" (2005) 29 *Melbourne University Law Review* 478, 484–88.

[5] As to the existence of conflicts of interest in these firms, see R Goode (ed), *Conflicts of Interest in the Changing Financial World* (London, Institute of Bankers, 1986), xv; Law Commission, United Kingdom, *Fiduciary Duties and Regulatory Rules*, Consultation Paper No 124 (London, HMSO, 1992), [1.1], [2.2] and [3.1]; and DA DeMott, *Fiduciary Obligation, Agency and Partnership: Duties in Ongoing Business Relationships* (St Paul, West Publishing Co, 1991), 671.

have in place information barriers such as ethical walls to respond to these conflicts.[6]

In the face of this contemporary reality, the fiduciary question has profound importance. First, without the existence of a fiduciary relationship (and absent any express contractual undertaking), an investment bank will not be obliged to avoid conflicts in providing securities underwriting services. Secondly, discharging such an obligation may require an investment bank to decline underwriting instructions from a prospective client, or else confront the distinctive remedial consequences of breaching the obligation, with the costly and embarrassing prospect of being restrained from acting on a transaction. This creates tension with the powerful financial imperative to accept underwriting engagements, which may be highly lucrative.[7] Thirdly, in view of these factors, the existence of such an obligation may create intractable difficulties for an investment bank and call into question the adequacy of its techniques for responding to conflicts. In fact, fiduciary analysis highlights a potential incompatibility between the traditional financial advisory role of investment banks and their modern organisational nature.

In recent years debate has arisen as to the appropriateness of the full-service investment banking business model and, in particular, whether firms should continue with it or disaggregate.[8] Judicial determination of the issue in the way suggested in this article would have wide-reaching consequences for the industry. The debate, however, lacks consciousness of fiduciary considerations. This is not surprising, since the fiduciary question under Anglo-Australian law has received no judicial, regulatory or scholarly attention and, indeed, investment banks have indicated publicly that they operate unconstrained by fiduciary obligations in similar circumstances.[9]

The article is organised as follows. Section B describes the process of raising capital, with emphasis on the relationship between the underwriter and the issuer. Section C outlines the theoretical approach adopted for considering the fiduciary character of this relationship and discusses the relevant law. Section D applies this law to the relationship and concludes that compelling arguments exist for characterising it as fiduciary. The parameters of the obligation to avoid

6 Law Commission, *ibid*, [4.5].

7 See JD Cox, RW Hillman and DC Langevoort, *Securities Regulation: Cases and Materials* (Gaithersburg, Aspen Law and Business, 3rd edn, 2001), 214. The work is regarded as improving a firm's prospects for future high value-added work, such as advising on merger and acquisitions; S Hayes III and P Hubbard, *Investment Banking: A Tale of Three Cities*, (Boston, MA, Harvard Business School Press, 1990), 214.

8 For instances of firms that have begun questioning the logic of financial conglomeration see, eg "Legg Mason: Its Biggest Bet Yet", *Economist*, 17 December 2005, 65–66 (Australian edition); "American Express Plans to Spin Off Wall St Unit", *The New York Times*, 2 February 2005, 1; "Morgan Stanley Under Fire", *Economist*, 9–15 April 2005, 60–61.

9 See, eg *Mannesmann v Goldman Sachs International* (unreported, November 18, 1999) (Ch D), [3], [8].

conflicts and contractual techniques for modifying or displacing fiduciary obligations are also discussed. Section E outlines the consequences for investment banks of the existence of the obligation, and conclusions are presented in Section F.

B. Raising Capital in Public Markets: the Forms and Process of Underwriting

1. Initial Public Offerings

This article focuses on the IPO, the seminal event in the life of a public company, because the relationship has a prominent and pervasive financial advisory dimension that raises the prospect of fiduciary obligations being imposed. The process of an IPO—from underwriter appointment to the public share issue—is complex, and riskier than other securities offerings.[10] In addition, unlike other offerings, the process is not abbreviated.[11] Moreover, the relationship between underwriter and issuer can be described with relative precision. However, to the extent that parallels exist with the underwriter–issuer relationship in other types of securities offerings (debt or equity), the analysis in this article will also apply.

2. Forms of Underwriting

Three underwriting methods are most common in Australia and England.[12] First, strict underwriting involves the underwriter (or a syndicate of underwriters) agreeing to subscribe at an agreed consideration for any securities, referred to as the "shortfall", that are not subscribed for by public investors in an offering by an issuer.[13] This is the most common underwriting method in Australia.[14]

The second involves the underwriter (or a syndicate of them) agreeing to purchase for cash all or a specified number of securities from the issuer at an

[10] As to the riskiness of the IPO, see Geisst, *supra* n 2, 66.

[11] See, eg "Equity Capital Markets: 2005's Top Firms Revealed" (2005) *International Financial Law Review* 20, 26–27, observing the greater work required of legal advisers for IPOs than for other securities offering transactions.

[12] Cf L Loss and J Seligman, *Securities Regulation* (Frederick, Aspen Law and Business, 3rd edn, 1989), vol 1, ch 2 (where five underwriting arrangements are described). For a general description of the three underwriting methods described in the text surrounding this note, see *Aberfoyle Ltd v Western Metals Ltd* (1998) 84 FCR 113.

[13] See *Re Licensed Victuallers Mutual Trading Association; Ex parte Audain* (1889) 42 Ch D 1; *Australian Investment Trust Ltd v Strand & Pitt Street Properties Ltd* (1931) SR (NSW) 266, on appeal *Australian Investment Trust Ltd v Strand & Pitt Street Properties Ltd* [1932] AC 735.

[14] In recent years, underwriters in Australia have adopted a variant of this practice, popularly referred to as "open constrained pricing underwriting". Typically, the underwriting arrangement (referred to as an offer management agreement) will relate only to the institutional aspect of the offering. That is, of the portion of shares offered for sale to institutions, the underwriter will be obliged to purchase those shares not in fact taken up.

agreed price for resale to the public.[15] Thus, the underwriter acts as a principal in relation both to the company and to purchasers of the securities.[16] Since there are typically limited circumstances in which underwriters may terminate their commitment to purchase the securities of the issuer,[17] none of which are within their control, this method of underwriting is referred to as "firm commitment" underwriting. It is a common method of underwriting for securities which are to be listed on the London Stock Exchange.[18]

The third arrangement involves one or more underwriters undertaking to use their "best efforts" to act as an agent to market the securities on behalf of the issuer at an agreed offering price.[19] The underwriter is not obligated to purchase the issuer's securities, nor to sell them to the investing public, leaving the issuer to bear the risk that all will not be purchased by the public and that the offering will not raise the desired capital. This method may still be observed in England, but is rarely seen in Australia.[20]

The risks assumed by an underwriter, including that the offer will not be taken up, will vary according to the underwriting method adopted. The underwriter's remuneration under all three methods will typically be calculated as a proportion of the total capital raised.

In England, the underwriter may also act as a sponsor of the issuer's application for listing on the London Stock Exchange. It is a requirement of seeking admission to the Official List of the Exchange that each listed company have a sponsor.[21] The sponsor's role is to supply information to the Financial Services Authority, the body required by statute to administer the statutory regulation of the issue of share capital in companies on the London Stock Exchange. The focus of this article, however, is on the underwriter's role in assisting the company to raise capital, quite apart from any responsibilities it may have to that company as a sponsor of its application for listing.

[15] See Loss and Seligman, *supra* n 12, 324; Cox et al, *supra* n 7, 207; EF Greene, "Investment Bankers: Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System" (1981) 56 *Notre Dame Lawyer* 756, 762; RW Jennings, H Marsh, JC Coffee, J Seligman, *Securities Regulation: Cases and Materials* (New York, Foundation Press, 8th edn, 1998), 89.

[16] Morse et al, *supra* n 3, [5.125].

[17] These are provided for in the underwriting agreement between the underwriters and issuer and include, for example, where a material adverse event affects the issuer. See generally Cox et al, *supra* n 7, 222–23; Jennings et al, *supra* n 15, 89–90.

[18] Morse et al, *supra* n 3, [5.125]. It is also the most common form of underwriting in the United States: see Greene, *supra* n 15, 762; Jennings et al, *supra* n 15, 89.

[19] See Loss and Seligman, *supra* n 12, 341; Cox et al, *supra* n 7, 207.

[20] See Hayes and Hubbard, *supra* n 7, 213. It may also be observed occasionally in the United States.

[21] See Morse et al, *supra* n 3, [5.343], citing Listing Rules, ch 8, [8.2.1R].

3. The Process of Underwriting

In response to the dominating principle of securities regulation—that public investors should be able to make informed decisions about investing in securities issues[22]—a standardised process has developed for taking a company public. While variations inevitably exist, in part because applicable securities regulations vary with international and other dimensions of an offering, there appears to be strong consistency in the relationship between the underwriter and the issuer in these transactions.[23]

The process begins with the appointment of an underwriter or underwriters and culminates some 6–9 months later with the listing of the company on an exchange and the public sale of its shares. During this period the relationship between the underwriter and the issuer is invariably close. By the time of appointment, the underwriter will have had preliminary negotiations and reached a tentative understanding only as to the proposed form of underwriting and offering terms.[24] Typically this will be documented in a brief engagement letter[25] that imposes no substantive obligations on the underwriter[26] and may even be expressed to be non-binding.[27] Indeed, in Australia it is not uncommon for a prospective issuer to refuse to sign the engagement letter.

In many cases, particularly with large offerings, the appointed underwriter (typically referred to as the lead manager[28]) will later select a number of other investment banks, referred to as sub-underwriters, to participate in an underwriting syndicate. Syndication is a means of spreading the risk associated with underwriting among other investment banks and allows an underwriter to participate in capital raisings of a magnitude greater than would be possible were it to act alone. This article considers the role of the lead manager (or co-lead managers, if more than one is appointed), rather than that of the sub-underwriter, which typically has minimal direct dealings with the issuer.

After its appointment and throughout the process, representatives of the underwriting firm will advise the company generally on achieving its strategic

[22] According to *Gower and Davies' Principles of Modern Company Law*, the dominating principle is "that members of the public who are offered company securities are entitled to full disclosure to them of the nature of what is on offer before they make a financial commitment". See P Davies, *Gower and Davies' Principles of Modern Company Law* (London, Thomson Sweet & Maxwell, 7th edn, 2003), 642. For the Australian position, see RP Austin and IM Ramsay, *Ford's Principles of Corporations Law* (Sydney, LexisNexis Butterworths, 12th edn, 2005), [10.010].

[23] A detailed description of the securities regulatory regime is beyond the purview of this article, except to the extent that it bears on the fiduciary question. This section of the article has benefited from recent interviews conducted by the author with investment bankers and solicitors with substantial experience in advising on initial public offerings.

[24] See Greene, *supra* n 15, 762.

[25] Cox et al, *supra* n 7, 219.

[26] *Ibid.*

[27] Jennings et al, *supra* n 15, 90.

[28] Geisst, *supra* n 2, 3.

objectives, including the merits of the proposed offering, alternative sources of capital (including selling the company or a segment of it) and the proposed uses of proceeds raised. It will also advise on the steps, including corporate restructuring, that the issuer can adopt prior to the offering to make it as "attractive" as possible to potential investors,[29] the timing of the offering (with the purpose of identifying the most favourable time to sell the securities[30]) and the design of the securities to be offered.[31] This involves the underwriter advising on interest rate levels, comparable offering prices, anticipated investor demand and a myriad of other financial considerations.[32] This advice is not merely the result of applying standard methodologies; it is strategic advice that reflects the underwriter's relative expertise and judgement in capital raising, acquired from extensive experience in capital markets transactions, and has a great impact on how successful issuers will be in raising capital.[33] Perhaps this is why issuers allow underwriters to exert great control during the course of the process.[34] Such is the underwriter's expectation that its advice will be followed that, where it is not, an underwriter has been known to withdraw from underwriting a transaction, even very late in the process.[35] In Australia the financial advisory function has assumed such significance that for large IPOs, independent financial advisory firms have been appointed to perform this and no other function.[36]

Various other overlapping stages are involved in the capital raising process. The underwriter will assist in preparing a prospectus, the offering document required to be provided to investors based on which an informed investment decision can be made. Providing information about the issuer, the terms of the issue and the risks associated with it,[37] this document in many cases will be drafted by the underwriter and its advisers—or at least be heavily influenced by the underwriter. Since the document must be complete and accurate as well as

[29] See generally Cox et al, *supra* n 7, 209.

[30] See Greene, *supra* n 15, 760.

[31] Geisst, *supra* n 2, 3.

[32] See Geisst, *ibid*, 65.

[33] *Ibid*. "The advice [investment bankers] give issuers of new securities concerning appropriate interest rate levels, offering prices, and anticipated investor demand has a great impact on how successful issuers will be in raising capital."

[34] See Greene, *supra* n 15, 760 as to the control that underwriters exert in the process of capital raising.

[35] See, eg J Anderson, "Goldman is Said to Have Quit Thomas Weisel Offering", *New York Times*, 12 January 2006, 2, reporting that investment bank Goldman Sachs allegedly withdrew from underwriting the IPO of an issuer after disagreement about the timing of the transaction.

[36] For example, for the proposed final privatisation of Telstra Ltd the Australian government appointed independent advisory firm Caliburn Partnership as its financial adviser. See M Sainsbury, "Another T3 Snub for Mac", *The Australian*, 17 January 2006, 17.

[37] For prospectus requirements specific to Australia, see Corporations Act 2001 (Cth), ss 710, 711 and the Australian Stock Exchange Listing Rules. For English requirements, see *Financial Services and Markets Act* 2000, Part VI.

serve a marketing function—to appeal to as many investors as possible—underwriter involvement is essential.

In conjunction with preparation of the prospectus, a process of investigation and verification, or "due diligence", will be conducted by the underwriter. This is to ensure that the prospectus is complete and accurate and to assist the underwriter in determining whether the underwriting is appropriate in view of the issuer's financial condition and prospects.[38] It also performs a critical investor-protection function and is regarded as enhancing capital market efficiency.[39] In Australia, due diligence by underwriters may serve as a defence for the underwriter against liability for errors or omissions in the prospectus.[40]

Due diligence reflects the underwriter's role as close confidant and trusted adviser. It involves the issuer disclosing to the underwriter, almost without limitation, information relating to its internal operations, as well as its strategic challenges and future prospects. The process continues through to the time of the public offering. The company will provide minutes of its board and committee meetings and those of its subsidiaries, all major contracts to which the company or its subsidiaries is a party, and any other material relevant to prospectus content or the investment bank's underwriting decision.[41] In addition, the issuer will make available for questioning its officers and other employees about matters such as business plans and financial performance.[42] The process has also been described as involving underwriters "studying the business from every angle, becoming familiar with the industry in which it functions, its future prospects, the character and efficiency of its operating policies and similar matters".[43] Accordingly, the underwriter will be privy to highly sensitive and confidential information about the issuer.

[38] Greene, *supra* n 15, 764.

[39] Professors Gilson and Kraakman argue that market institutions, such as investment banks, serve the function of reducing information costs associated with the sale of securities, and thereby facilitating efficiency in the capital market: RJ Gilson and RH Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 *Virginia Law Review* 549, 554. By conducting due diligence, an underwriter verifies information provided by the issuer to dispersed investors and implicitly pledges its reputation to protect the interests of those investors. This "gatekeeper" role is also performed by others, including accountants, directors and lawyers. See JC Coffee, "Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation" (1997) 52 *The Business Lawyer* 1195, 1232–33; JC Coffee, "Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms" (2004) 84 *Boston University Law Rev*iew 301, 302–9.

[40] See *Corporations Act* 2001 (Cth), s 731.

[41] For matters normally covered by due diligence, see L Nicholas, "The Integrated Disclosure System and its Impost Upon Underwriters' Due Diligence: Will Investors Be Protected?" (1983) 11 *Securities Regulation Law Journal* 3, 13–14, citing S Fortenbaugh, "Underwriters' Due Diligence" (1981) 14 *Review of Securities Regulation* 799.

[42] See Geisst, *supra* n 2, 7.

[43] *United States v Morgan* 118 F Supp 621, 653 (SDNY 1953), quoted in Greene, *supra* n 15, 764.

An intrusive process, due diligence has also been described as being "adverse" to the issuer,[44] and this is true in the sense that the underwriter will seek independently to verify information presented by the company. But the process is nevertheless cooperative. Due diligence assists with prospectus drafting and enables the underwriter to perform its advisory function. It typically strengthens bonds between underwriter and issuer, making it more likely that the issuer will turn to the investment bank for future services. In *United States v Morgan*[45] the court recognised this, explaining that issuers will typically use the same underwriters repeatedly due to "the saving in the time and labor of the officers and employees of an issuer, which would have to be spent in teaching a new investment banker the intricacies of the business, and the financial set up of the company".[46] Furthermore, the court explained, "many of the matters to be discussed are of such a character that company officials desire to have such conversations only with those whom they trust, and in whose integrity and competence they have complete confidence".[47]

During the capital raising process, the underwriter and the issuer will execute an underwriting agreement—a detailed contract setting out their respective rights and obligations. Negotiation of the agreement represents one point in the process at which there is tension between the interests of the underwriter and those of the issuer. The agreement will set out obligations regarding the purchase of shares, although their exact content will depend on the type of underwriting involved. Rarely will the agreement outline the advisory dimension of the relationship or impose obligations on the underwriter about the advice to be provided. Curiously, in many cases the agreement will be executed only after much work has already been performed by the underwriter in guiding the issuer through the prospectus drafting and other stages of the process.

Towards the time of the public offering, when the prospectus is nearly complete and most offering terms have been decided upon, the underwriters will assist the issuer to market the shares to potential investors to the extent permitted by law.[48] With the purpose of gauging (and generating) demand for the proposed offering and to determine the price that investors are likely to be prepared to pay for the securities, the underwriters and issuer will embark on a series of "roadshow" presentations. These are meetings held with fund managers, selected potential investors and research analysts at which company executives provide information and answer questions about the issuer and the proposed offering.

[44] See *Escott v BarChris Construction Corp* 283 F Supp 643, 696 (SDNY 1968): "In a sense, the positions of the underwriter and the company's officers are adverse"; *Feit v Leasco Data Processing Equipment Corp* 332 F Supp 544, 582 (EDNY 1971): "Tacit reliance on management assertions is unacceptable; the underwriters must play devil's advocate."

[45] See *supra* n 43, 817.

[46] *Ibid.*

[47] *Ibid.*

[48] For advertising restrictions, see Morse et al, *supra* n 3, [5.374]–[5.375].

With the same purpose, the underwriters will adopt other measures, such as meeting with their other clients.

After the prospectus has been largely finalised, the underwriting agreement executed, and marketing activities completed, the underwriter will advise the issuer on the price at which the securities will be offered for sale.[49] Since both parties will benefit from a high offering price, their immediate financial interests would appear to be aligned when pricing the shares. At the same time, the underwriter will have countervailing considerations: it must purchase – or be left holding (depending on the form of underwriting) – any securities unsold to the public; it will have allegiances to potential purchasers, who will expect an offer price with upward trading potential[50]; and it must – for the benefit of its market reputation – ensure that the price is set to meet expected demand. For these reasons, pricing discussions will be delicate. However, due to its greater expertise and contact with potential investors, the underwriter's advice typically plays a central role in the outcome.

As with the pricing decision, the underwriter's advice will heavily influence the timing of an offering. This is another aspect of its financial advisory role. Offerings are commonly accelerated or delayed in order to sell the securities in "windows of opportunity", when market conditions are considered optimal. Such is the influence of the underwriter's advice in this regard, and its concern that its advice be followed, that one underwriter was recently reported to have withdrawn from underwriting an IPO after disagreeing with the issuer about the timing of the transaction.[51]

Concurrent with the public sale of their securities, companies will typically be admitted to the listed market of the London Stock Exchange or the Australian Stock Exchange,[52] as the case may be, thereby enabling trading of these securities.[53] After the public offering has occurred, the underwriter will have no

[49] In recent years, underwriters in Australia have adopted a "bookbuild" process of pricing shares in some IPOs. This process involves an underwriter, acting in the capacity of a "bookrunner", determining the offering price of shares by adopting a process that is rarely publicly disclosed.

[50] Numerous studies establish that underwriters generally underprice their securities, at least in the case of IPOs: RP Beatty and JR Ritter, "Investment Banking, Reputation, and the Underpricing of Initial Public Offerings" (1986) 15 *Journal of Financial Economics* 213; RG Ibbotson "Price Performance of Common Stock New Issues" (1975) 3 *Journal of Financial Economics* 235; JR Ritter, "The 'Hot Issue' Market of 1980" (1984) 57 *Journal of Business* 215; JR Ritter, "The Long-run Performance of Initial Public Offerings" (1991) 46 *Journal of Finance* 3; Hayes and Hubbard, *supra* n 7, 214–15.

[51] See, eg J Anderson, *supra* n 35.

[52] Terminology differs in Australia. A company is regarded as being "listed" on the Australian Stock Exchange and its securities as being "quoted".

[53] Admission of securities to the listed market of the London Stock Exchange are subject to the *Financial Services and Markets Act* 2000, Part IV. The equivalent provisions for companies listing on the Australian Stock Exchange are its Listing Rules.

further obligation to the issuer, and the syndicate, if one was formed, will disband.[54]

The underwriter's role throughout the IPO process is one of trusted financial counsellor. Although its other functions—marketer of the shares, assumer of risk and gatekeeper for the market—are clearly important, the financial advisory function is a core role. It allows—indeed, requires—the underwriter to bring to bear its extensive experience of capital markets for the benefit of the infant company. The due diligence process ensures that all aspects of the company, however confidential or sensitive, are disclosed to the underwriter. With this advantage, the underwriter can advise with great influence on the wisdom of the IPO, alternative forms of fundraising, the structure of the company, the design and price of the securities, the conduct and timing of the offering and anticipated investor demand. The advice will affect the amount of capital raised and its cost[55] and, over the course of many months, will guide the company to the public capital market. Although the underwriter and issuer are commercial parties, their relationship in this context cannot be characterised as being at arm's length on equal footing.

C. Fiduciary Characterisation

1. Theoretical Orientation

Since the underwriter–issuer relationship is not an "accepted" category of fiduciary relationship,[56] this article applies twin approaches to determine the incidence of fiduciary obligations. The first is to investigate the factual relationship for features or indicia that have been judicially endorsed for identifying fiduciary character. These include the existence of an undertaking by

[54] Geisst, *supra* n 2, 8.

[55] *Ibid*, 9: "The behaviour of investment bankers is key to the reception that new issues experience and directly affects the cost of capital for a company." See also 65, 66.

[56] "Accepted" or "established" relationships include those between trustee and beneficiary, agent and principal, solicitor and client, director and company and partner and co-partner. See *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41, 96; Lord Goff of Chieveley and G Jones, *The Law of Restitution* (London, Sweet & Maxwell, 6th edn, 2002), 33-001. Additional "accepted" categories of fiduciaries include receivers in bankruptcy and creditors, liquidators and contributories (see J Glover, *Equity, Restitution and Fraud* (Sydney, LexisNexis Butterworths, 2004), 2.3; P Parkinson, "Fiduciary Obligations", in P Parkinson (ed), *The Principles of Equity* (Sydney, Lawbook Co, 2nd edn, 2003), [1003]–[1012]; RP Meagher, JD Heydon and MJ Leeming, *Meagher, Gummow and Lehane's Equity Doctrines and Remedies* (Sydney, Butterworths, 4th edn, 2002)), promoters of a company and its subscribers (*Aequitas Ltd v Sparad No 100 Ltd (formerly Australian European Finance Corporation Ltd)* (2001) 19 ACLC 1006), and a member of the Securities Services and the Crown (*Attorney-General v Guardian Newspapers Ltd (No 2)* [1990] 1 AC 109; Goff and Jones, [33-017]). In Australia, the relationship between employer and employee has been said to be fiduciary (*Hospital Products*, *supra* n 56, 96), but this is not necessarily the case in the United Kingdom (see Goff and Jones, [33-001]).

a person (the fiduciary) to act in the interests of another person;[57] a relation of trust and confidence;[58] vulnerability to another's power or vulnerability necessitating reliance;[59] power by a person (the fiduciary) to affect the interests of the other person in a real or practical sense;[60] and a reasonable expectation that a person (the fiduciary) will act in the interests of another in and for the purposes of a relationship.[61]

Particular emphasis is given to the reasonable expectations criterion since it has also been regarded as a unifying theory of fiduciary principle[62]—not just a feature identifying fiduciary character—and thus provides a normative basis for assessing whether the extension of fiduciary principles to the relationship in question is justified. Considering this criterion with other judicially endorsed features carries legitimacy at a doctrinal level[63] and "as a matter of practicality, [reduces] the uncertainties that arise" from applying the reasonable expectations criterion alone.[64]

Propounded by Professor (now Justice) Finn, the reasonable expectations criterion holds that a fiduciary relationship arises where, within the scope of the relationship in question or in respect of a particular matter, a person can be reasonably expected to act in the interests of another in and for the purposes of the relationship.[65] What must be shown "is that the actual circumstances of a

[57] *Hospital Products, supra* n 56, 96–97; *Bristol & West Building Society v Mothew* [1998] ch 1, 16–19; [1996] 4 All ER 698, 711–12.

[58] *Bristol and West Building Society*, *ibid*, 711–12 (Millett LJ); *Hospital Products*, *supra* n 56, 69 (Mason J), citing *Tate v Williamson* (1866) LR 2 Ch App 55, 61; *Coleman v Myers* [1977] 2 NZLR 225, 325.

[59] *Hospital Products, supra* n 56, 142 (Dawson J); *Mabo v Queensland (No 2)* 175 CLR 1, 200–1 (Toohey J); *Australian Securities Commission v AS Nominees Ltd* (1995) 62 FCR 504, 521; 133 ALR 1, 17 (Finn J); Sir P Millett, "Equity's Place in the Law of Commerce" (1998) 114 *Law Quarterly Review* 214, 219.

[60] *Hospital Products*, *supra* n 56, 96–97 (Mason J).

[61] *Hughes Aircraft Systems International v AirServices Australia* (1997) 76 FCR 151, 237; *Australian Securities*, *supra* n 59, 521 (Finn J); *Glandon Pty Ltd v Strata Consolidated Pty Ltd* (1993) 11 ACSR 543, 556–57; *Doolan v Dare* [2004] FCA 682, [39]; PD Finn, "The Fiduciary Principle", in T Youdan (ed), *Equity, Fiduciaries and Trusts* (Toronto, Carswell, 1989), 46.

[62] See, eg R Flannigan "The Boundaries of Fiduciary Accountability" (2004) 83 *Canadian Bar Review* 35, 54–6; M Conaglen, "The Nature and Function of Fiduciary Loyalty" (2005) 121 *Law Quarterly Review* 452. Cases referring with approval to the "reasonable expectations" criterion as a theoretical basis of the fiduciary principle, whether with or without attribution to Finn, include *Wik Peoples v Queensland* (1996) 187 CLR 1, 95–96 (Brennan CJ); *United States Surgical Corporations v Hospital Products International Pty Ltd* [1983] 2 NSWLR 157, 208; *Commonwealth Bank of Australia v Smith* (1991) 42 FCR 390; *Glandon Pty Ltd v Strata Consolidated Pty Ltd, supra* n 74; *Hodgkinson v Simms* (1994) 117 DLR (4th) 161; *Merrill, Lynch, Pierce, Fenner Inc v Boeck* (1985) 377 NW 2d 605, 609; *Brandeis (Brokers) Ltd v Black* (1999 Folio 1553, 2000 Folio 207, 25 May 2001).

[63] See, eg *Hughes Aircraft Systems*, *supra* n 61, 237; *Australian Securities*, *supra* n 59, 521 (Finn J); *Glandon Pty*, *supra* n 61; *Doolan v Dare*, *supra* n 61, [39].

[64] *Pilmer v The Duke Group Limited (in liq)* [2001] HCA 31 (31 May 2001), [136]. In England, Millett LJ, writing extrajudicially, has recommended that English courts "should direct [their] efforts, not to finding a definition of the concept of 'fiduciary', but to defining the characteristics of the various fiduciary relationships". See Millett, *supra* n 59, 218.

[65] *Hughes Aircraft Systems, supra* n 61, 237; *Australian Securities*, *supra* n 59, 521 (Finn J); Finn, *supra* n 61, 46.

relationship are such that one party is entitled to expect that the other will act in his interests".[66]

The second approach applied in this article is to reason by analogy from previously decided cases and established categories of fiduciary relationship, having regard to the actual facts of the relationship in question.[67] This clearly overlaps with the first since in making analogies courts may have regard to similarities in terms of the features identifying fiduciary character. It also helps ensure that legal developments in the application of fiduciary principle will maintain the continuity of the law and preserve its coherence.[68]

At this point, two weaknesses of the "reasonable expectations" criterion deserve mention. First, as Deborah DeMott has observed, the criterion implicates the "probabilistic projections" of the principal as to whether the alleged fiduciary will in fact act loyally, with the result that no reasonable expectation will arise where the principal has "some basis to doubt whether [an alleged fiduciary] will fulfill that expectation".[69] Accordingly, the reasonable expectations criterion could deny the existence of fiduciary obligations where there had been a history of disloyal conduct by the alleged fiduciary (on the basis of no reasonable expectation being formed) in circumstances where the principal would be entitled to expect loyalty. DeMott's "justifiable expectation" of loyalty overcomes this deficiency.[70] For the purpose of this article, however, which involves attributing fiduciary character to a category of relationship rather than to a particular relationship between individual parties, it is submitted that no significant difference exists between the two criteria in their application.

The other weakness is that, alone, the reasonable expectations criterion fails to adequately explain the *form* of fiduciary obligations, which are proscriptive in nature—prohibiting conduct, without certain authorisations, rather than compelling it.[71] Richard Nolan asserts that additional explanatory power is furnished by a consideration of the practicability *ex ante* of stipulating (or having the law imply) specific constraints on a person's conduct—an exercise that will depend on the nature of the task in question and its amenability to assessment.[72]

[66] Finn, *supra* n 61, 46.

[67] See *Hospital Products*, *supra* n 56, 96; Glover, *supra* n 56, [2.8]–[2.10]; and DeMott, *supra* n 5, 2–3.

[68] See *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241, 298, referring to Sir O Dixon, "Concerning Judicial Method" (1956) 29 *Australian Law Journal*, 468, 472, 475.

[69] DA DeMott, "Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences" (2006) 48 *Arizona Law Review* 925, 937–8.

[70] According to DeMott, the "defining or determining criterion should be whether the plaintiff (or claimed beneficiary of a fiduciary duty) would be justified in expecting loyal conduct on the part of an actor and whether the actor's conduct contravened that expectation". DeMott, *ibid*, 926.

[71] See *Breen v Williams* (1996) 186 CLR 71; *Bristol & West Building Society*, 711–12; *Maguire v Makaronis* (1997) 188 CLR 449; *Beach Petroleum v Kennedy* (1999) 48 NSWLR 1, 46–47.

[72] RC Nolan, "The Legal Control of Directors' Conflicts of Interest in the United Kingdom: Non-Executive Directors Following the Higgs Report" (2005) 6 *Theoretical Inquiries in Law*, 413, 422.

For example, the managerial role of the company director may be performed in "so many different, unobjectionable ways" and "it is exceptionally difficult to stipulate specifically for the conduct to be undertaken" by the director without abolishing managerial freedom.[73] To avoid the "chilling effect" on entrepreneurial activity that imposing strict duties of care and skill would have and to avoid the uncertainty of application that imposing broad prescriptive duties would involve, English law has responded by imposing obligations that proscribe conduct that would jeopardise performance of the task in question.[74] This article considers the factors referred to by Nolan in determining whether a reasonable expectation of loyalty exists.

A final observation is that the heavy reliance of courts of each jurisdiction on decisions of the other jurisdiction,[75] and the influence of Finn's scholarship in both,[76] make it possible to consider the fiduciary question under the body of Anglo-Australian fiduciary law. Differences in legal principle across national boundaries will exist,[77] although in this context they are subtle and do not affect the analysis unless otherwise noted.

2. Identification of Fiduciary Relationships

(a) Financial and Investment Advisers as Fiduciaries

Fiduciary obligations may be imposed in a commercial context on a party in a relationship of confidence where an incident of the relationship is the giving of financial or investment advice.[78] More specifically, the relationships of stockbroking firm and client,[79] bank and customer,[80] corporate adviser and client,[81] and analogous relationships may be fiduciary in character where the adviser holds itself out as an expert in financial or investment matters and

[73] *Ibid*, 422–23.

[74] *Ibid*, 423.

[75] Recent examples of English courts citing Australian authority on fiduciary doctrine include *Murad v Al-Saraj* [2005] EWCA Civ 959; *Bristol & West Building Society*, *supra* n 57, Ch 1; *Hilton v Barker Booth & Eastwood* [2005] UKHL 8, [29], [2005] All ER 651, 660; *Kelly v Cooper* [1993] AC 205. Australian courts regularly refer for guidance to decisions of English courts.

[76] See, eg *Bristol & West Building Society*, *supra* n 57, 711–12; *Sinclair Investment Holdings SA v Versailles Trade Finance Limited* [2005] EWCA Civ 722, [9]; *Pilmer*, *supra* n 64, 215, 219; *Breen v Williams*, *supra* n 71, 92 n 69, 93 n 73, 95 n 83, 113 n 161, 126 n 198.

[77] See A Mason, "Equity's Role in the Twentieth Century" (1998) 8 *King's College Law Journal* 1, 5; Millett, *supra* n 59, 215; Law Commission, *supra* n 5, 2.4.4; and Goff and Jones, *supra* n 56, [33-003].

[78] For a more detailed discussion of the law, see Tuch, *supra* n 4, and A Tuch, "Obligations of Financial Advisers in Change-of-control Transactions: Fiduciary and other Questions" (2006) 24 *Company and Securities Law Journal* 488.

[79] See, eg *Daly v Sydney Stock Exchange* (1986) 160 CLR 371.

[80] See, eg *Commonwealth Bank of Australia v Smith, supra* n 62; cf *Finding v Commonwealth Bank of Australia* [2001] 1 Qd R 168.

[81] See, eg *Aequitas*, *supra* n 56; cf *Arklow Investments Ltd v Maclean* [2000] 1 WLR 594.

undertakes to provide advice of that nature to the client or customer.[82] This formulation for the incidence of fiduciary obligations—holding out and undertaking by the adviser—has been equated with a requirement that the adviser's conduct create in the client an expectation that it will advise in the client's interests,[83] an apparent reference to Finn's reasonable expectations criterion. This view recognises that an undertaking to advise may create the "fiduciary expectation" on the part of the person to whom the undertaking has been made.[84]

Also apparent in each of the advisory relationships found to be fiduciary—although not always expressly mentioned by the court—was trust or confidence reposed in the adviser, giving it some measure of influence over the other party in respect of a transaction of significance to that party. In addition, the party to whom the advice is provided must rely on the financial or investment advice. Where a client has already decided on a course of action before receiving advice to act in that way, fiduciary obligations will not arise.[85]

The nature of the advice provided is significant to the determination of whether a fiduciary relationship arises. It must be investment advice or financial advice (expressions used synonymously in the cases). Accordingly, where a court finds that no financial advice was given, it will resist imposing fiduciary obligations.[86] The giving of "corporate advice" may also give rise to fiduciary obligations, it being regarded as not materially different in terms of fiduciary obligation from financial advice.[87]

In no case do courts appear to have explicitly discussed what constitutes financial, investment or corporate advice for the purpose of identifying fiduciary character. But these expressions, while capturing advice of broad scope, are far from nebulous. In *Daly v Sydney Stock Exchange*[88] the advice related to how or where to invest available funds for financial return, and in *Commonwealth Bank of Australia v Smith*[89] the advice related to weighing up competing investment opportunities and the wisdom of investing in a particular transaction, this involving the assessment of the contract price and funding options. In *Aequitas*[90]

[82] See *Daly*, *supra* n 79, 385; *Aequitas*, *supra* n 56, [307].

[83] See *Commonwealth Bank of Australia*, *supra* n 62, 391 where the Full Federal Court of Australia (Davies, Sheppard and Gummow JJ) apparently saw the "expectation" requirement as grounded in *Daly*, *supra* n 79, which established the requirement of holding out and undertaking.

[84] Scholars have also recognised this: see PD Finn, "Fiduciary Law and the Modern Commercial World", in E McKendrick (ed), *Commercial Aspects of Trusts and Fiduciary Obligations* (New York, Oxford University Press, 1992), 9 n 18; KF Sin, *The Legal Nature of the Unit Trust* (Oxford University Press, 1997), 163.

[85] See *Finding*, *supra* n 80.

[86] See *Grubic v Commonwealth Bank of Australia* [1993] Aust Contract Rep [90-033].

[87] *Aequitas*, *supra* n 56, [310].

[88] See *supra* n 79.

[89] See *supra* n 62.

[90] *Aequitas*, *supra* n 56.

the advice broadly related to investment opportunities (which included buying shares of another company) and raising funds for or financing those opportunities; more specifically, it related to the structure of the client, the merits and structure of a securities issue to raise funds, and the relative merits of a number of investment opportunities for those funds. Taken together, the advice for purposes of fiduciary characterisation may be broadly described as advice on the merits and other aspects of raising funds (either privately or publicly, by either debt or equity instruments) and of investing or spending those funds; or, in other words, as relating to the wisdom or merits of entering into a particular investment and its alternatives, to financing and timing considerations, and to documenting and implementing the investment decision.[91]

Such advice clearly has the capacity to affect the interests of the client and cannot be provided by applying a methodology or by "number crunching". It is strategic advice in the sense that it requires the exercise of judgement and the application of financial acumen to assist a person lacking these attributes (in relative terms) to make what can broadly be described as investment decisions. Moreover, providing the advice requires that regard be had to the individual circumstances and objectives of the client, and consequently the advice will vary according to those considerations.

It follows from this description of the law that fiduciary obligations may be owed to a financially sophisticated client as even it may expect loyal conduct from its adviser. Such a client may rely on its adviser for information and advice, particularly in the context of a significant transaction for the client, and thus be considered vulnerable for purposes of fiduciary characterisation.[92] This is not to deny that a client's sophistication may be relevant to the factual question of whether an adviser provided financial or investment advice, but only to say that it will not otherwise be an obstacle to the existence of fiduciary obligations.[93]

The scope of the consequent fiduciary obligations will be confined to the giving of advice of the requisite type.[94] Accordingly, fiduciary obligations will be imposed "to the extent of [the] advice"[95] or only in respect of the advisory

[91] Characterising the nature of advice in this way is consistent with the High Court's approach in *Pilmer*, *supra* n 64, 197, which implicitly recognised that advice "about the efficacy or wisdom of [a] takeover" (itself a form of investment by the bidder) is "advice in the relevant sense for the purposes of liabilities as a fiduciary".

[92] See Law Commission, *supra* n 5, [2.46], observing that, for purposes of fiduciary characterisation, "vulnerability can be shown by factors such as dependence upon information and advice, the existence of a relationship of confidence and the significance of a particular transaction for the parties".

[93] See A Tuch, "Obligations of Financial Advisers in Change-of-control Transactions: Fiduciary and other Questions" (2006) 24 *Company and Securities Law Journal* 488, 503–4.

[94] In Daly's case, the question was framed as whether, "in advising [its client]", the stockbroking firm was in the position of a fiduciary. *Daly*, *supra* n 79, 384.

[95] Glover, *supra* n 56, [2.67].

aspect or dimension of the relationship.[96] It follows that fiduciary obligations may not be owed in respect of other aspects of the relationship between an adviser and its client,[97] assuming, of course, that aspects of a relationship can be discretely identified.

(b) The Securities Underwriter as Fiduciary

Like the financial adviser–client relationship, the relationship between a securities underwriter and its client may give rise to fiduciary obligations. This is so because, as described above, the underwriter's role typically involves the provision of financial advice.

Justice Lehane's decision in *Hadid v Lenfest Communications Inc*[98] sheds some light on the question. The matter involved business dealings for satellite pay television licences that were allocated by the Australian government in the 1990s. The applicant alleged that Bain, described as a financial advisory firm, owed fiduciary obligations in respect of its involvement in the proposed securities offering by an alleged joint venture, which included the applicant. The purpose of the venture was to raise funds to purchase the licences. Bain was introduced to the applicant as a prospective securities underwriter and proposed an indicative timetable for the securities offering. From time to time Bain also offered general views to the applicant relating to the proposed securities offering and financial market conditions, and at one point provided a letter expressing views as to the feasibility of a securities offering on particular terms. The applicant alleged that Bain assumed fiduciary obligations to him and to the joint venture, which it had breached by subsequently advising parties with interests adverse to those of the applicant.

The applicant alleged that fiduciary obligations arose because Bain had "held itself out as having special skill in providing financial and investment advice and knew, or ought to have known, that [the applicant] relied upon Bain to provide full and frank advice".[99] It argued that Bain acted as both underwriter and financial adviser, and not simply as underwriter. The applicant did not allege that fiduciary obligations arose in respect of "underwriting" alone. Bain asserted that no fiduciary obligations arose since it had repeatedly made it clear that it would not accept an advisory role in the circumstances. It is apparent from the

[96] This is consistent with the decision of the Court of Appeals of New York in *EBC I* that the scope of any fiduciary relationship in the underwriting context "is limited to the underwriter's role as advisor". *EBC I, Inc v Goldman Sachs & Co* (2005) 5 NY 3d 11, 176.

[97] Numerous cases establish that a person may be a fiduciary in one or more activities but not in others: *New Zealand Netherlands Society "Oranje" Inc v Kuys* [1973] 1 WLR 1126, 1130; *Phipps v Boardman* [1967] 2 AC 46, 127; *Birtchnell v Equity Trustees Executors & Agency Co Ltd* (1929) 42 CLR 384, 408; *Hospital Products*, *supra* n 56, 98.

[98] [1999] FCA 1798.

[99] *Ibid*, [793].

reasons that the parties and the court regarded "underwriting" as excluding any financial advisory aspect.

Justice Lehane found that Bain had not provided financial advice but instead had expressed views "gratuitously, no doubt in the hope that [it] would be rewarded, ultimately, by being appointed underwriter".[100] In fact, Bain's views, including those expressed in its letter, were "little more than a 'pitch' for an underwriting role—stressing the strength and credentials of Bain".[101] Even the indicative timetable that Bain provided was part of the "pitch", rather than "advice in any usual sense of the word".[102] Justice Lehane acknowledged that "advisers may, and often do, have fiduciary obligations".[103] But this was not such a case; a commercial party had openly pursued an interest of its own and, in the course of so doing, had given advice, or offered opinions, "in a promotional, non-binding or relatively casual way" and the law did not extend to impose fiduciary obligations in these circumstances.[104] Justice Lehane denied that fiduciary obligations were owed by Bain to the applicant or to the alleged joint venture.

It is implicit in Justice Lehane's reasons that the provision of financial advice in a securities underwriting context may furnish a basis for the imposition of fiduciary obligations. However, he was not required to decide this question since no such advice had been provided. Also significant is the implicit assumption in the reasoning that securities underwriting excludes a financial advisory dimension—even though the court did not explain what it meant by either activity. Unless underwriting is understood in a narrow sense of including only a risk-assumption role, the court's assumption appears unfounded.

In England the character of the underwriter–issuer relationship as fiduciary or not has not been tested, although in *United Pan-Europe v Deutsche Bank*[105] the plaintiff appears to have either overlooked the argument or considered that it

[100] *Ibid*, [814].
[101] *Ibid*, [814].
[102] *Ibid*, [815].
[103] *Ibid*, [817], quoting from Finn, "Fiduciary Law and the Modern Commercial World", *supra* n 84.
[104] *Ibid*, [817].
[105] [2000] 2 BCLC 461, per Morritt LJ, Ward LJ, Charles J agreeing. The reasons of Arden J in *Eagle Trust plc v SBC Securities Ltd* [1995] BCC 231 could be taken to suggest that the functions of underwriter and financial adviser are distinct for purposes of fiduciary obligation. Arden J asserts that "in underwriting . . . [the underwriter] was not in my judgment carrying out the functions of financial adviser" (at 249) and that there was no overlap between the underwriting and financial advisory capacities in which the underwriter acted (at 251). These assertions do not diminish the reasoning in this article for three reasons. First, the underwriting in question did not relate to an IPO, which is the context under inquiry here. Second, Arden J's comments must be understood in light of peculiar facts: the financial advisory role concerned a takeover transaction, whereas the underwriting role concerned separate, non-overlapping transactions—a rights issue and a so-called "cash alternative offer". Third, the financial advisory role itself was unusual—and distinct from the financial advisory role described in this article—because it excluded advice "on the commercial merits of the [transaction in question]" (at 234).

would fail. Deutsche Bank was found to owe fiduciary obligations to a company, UPC, to whom it had loaned funds. Without clearly stating its reasons for the existence of the fiduciary relationship, the court asserted that "the issue is not the existence of the fiduciary duty but of its scope",[106] and that the duty's scope "could only be determined at the trial".[107] However, the basis for fiduciary characterisation appears to have been the regular provision of confidential information to Deutsche Bank, which UPC was required to provide under loan contracts among it and a number of banks, including Deutsche Bank. The court did not dispute UPC's allegation that it arose

> "from the key banking relationship formerly existing between [it and Deutsche Bank], the mutual trust and confidence without which it could not properly operate and the requirement duly performed that UPC pass to [Deutsche] confidential information . . . on a regular basis". [108]

It allowed an appeal against the discharge of an injunction that had been granted to restrain the bank from breaching its duty of loyalty.

The significant feature for present purposes is that Deutsche Bank had underwritten UPC's IPO in 1999 and gained confidential information in the course of that transaction. However, no argument was made that fiduciary obligations arose from these dealings. It may be that the argument was not pursued because it is likely that any fiduciary obligations that did arise would have terminated at the conclusion of the securities offering.[109]

Although fiduciary decisions from North America carry limited precedential value because of the different conception of fiduciary obligations,[110] one recent decision deserves attention. In *EBC I, Inc v Goldman Sachs & Co*[111] an action was brought on behalf of the issuer against the managing underwriter of an IPO alleging, among other claims, that the underwriter had breached its fiduciary duty to the company to disclose conflicts of interest concerning the offering.[112] The Court of Appeals of New York considered a motion to dismiss the cause of action and held, by majority, that the allegations were sufficient to state a claim against the underwriter for breach of fiduciary duty.

[106] *Ibid*, 482 (Morritt LJ).
[107] *Ibid*, 481 (Morritt LJ).
[108] *Ibid*.
[109] See *Prince Jefri Bolkiah v KPMG (a firm)* [1999] 2 AC 222, 235. See Section D3 *infra*.
[110] As to the extent to which Anglo-Australian understanding of fiduciary obligations differs from the North American, see *Breen v Williams*, *supra* n 71; Parkinson, *supra* n 56, [1039]; Nolan, *supra* n 72, 420 fn 29.
[111] See *supra* n 96.
[112] The issuer (originally known as eToys, Inc, but renamed EBC I Inc by the time of the proceedings) had filed a voluntary petition for reorganisation under Chapter 11 of the United States Bankruptcy Code and the Bankruptcy Court appointed and authorised the Official Committee of Unsecured Creditors to bring the action against the managing underwriter on behalf of the company.

The defendant, which had been contracted to underwrite the issuer's securities issue on a "firm commitment" basis, was alleged to have entered into undisclosed arrangements with potential investors whereby the investors were obligated to "kick back" to the underwriter a portion of any profits that they made from the sale of the issuer's securities after the offering. The plaintiff alleged that the underwriter had a secret incentive to underprice its shares since a lower price would result in a higher profit to the potential investors upon the resale of the shares (assuming the share price increased—which it did) and thus a higher payment to the underwriter.[113]

The plaintiff alleged that an advisory relationship arose independently of the underwriting agreement and was fiduciary in nature. In particular, it alleged that a fiduciary obligation arose requiring the underwriter "to disclose any conflict of interest concerning the pricing of the IPO"[114] and thus required disclosure of the compensation arrangements.

The majority explained that the fiduciary relationship is necessarily "fact-specific" and is "grounded in a higher level of trust than normally present in the marketplace between those involved in arm's length business transactions".[115] It further explained that a cause of action for breach of fiduciary duty may survive, for pleading purposes, "where the complaining party sets forth allegations that, apart from the terms of the contract [being the underwriting agreement], the underwriter and issuer created a relationship of higher trust than would arise from the underwriting agreement alone".[116] The issuer's and underwriter's interests in pricing the shares were aligned because of the underwriter's compensation structure, which rewarded it in proportion to the proceeds of the offering. This alignment of interests would have supported the issuer's trust that the underwriter would act in its interests when pricing the shares, the majority asserted.[117] In these circumstances, a fiduciary relationship may exist and its scope "is limited to the underwriter's role as advisor".[118] The fiduciary obligation that arises is "to disclose to the issuer any material conflicts of interest that render the advice suspect".[119] It is evident that the underwriter's advice on the price of the securities was considered to be part of its advisory role.

[113] *Ibid*, 174. Read J, who dissented on the question of fiduciary duty, explained that that plaintiff's theory "had to be that [the underwriter], whose underwriting compensation was a percentage . . . of aggregate offering proceeds, stood to make more money on kickbacks from [the compensation arrangements with potential investors] than it would have earned on its increased compensation from selling shares at some high, theoretically 'correct' price": at 179.

[114] *Ibid*, 175.

[115] *Ibid*.

[116] *Ibid*.

[117] *Ibid*, 176.

[118] *Ibid*.

[119] *Ibid*.

The majority rejected the defendant's arguments that its conclusion offended the principle that fiduciary obligations do not exist between commercial parties operating at arm's length and would adversely affect the underwriting industry. The majority emphasised that the fiduciary relationship was alleged to arise beyond the relationship arising from the underwriting agreement alone.

Read J dissented on the question of whether a fiduciary relationship arose, asserting that fiduciary obligations should not be injected into "sophisticated, counselled parties' arm's length commercial dealings"[120] and because of the uncertainty of determining how the resulting fiduciary obligations "may fit into or conflict with" the regulatory regime for issuing securities.[121]

In the result, the Court of Appeals found that the plaintiff had sufficiently stated a claim for breach of fiduciary duty and declined to dismiss the complaint alleging a breach of that duty. The plaintiff is yet to establish its allegations at trial.

It is significant that the court's factual analysis of the financial advisory aspect of the underwriter–issuer relationship is consistent with the description outlined in Section B above.

3. Contractual Techniques to Displace or Modify Fiduciary Obligations

Parties may contractually displace fiduciary obligations or, if they arise, modify their content and scope. They may also exclude liability in the event of fiduciary breach.[122] The limits on the effectiveness of these techniques are not explored here. Despite the amenability of fiduciary obligations to contract, however, the fiduciary question remains important for a number of reasons. First, doubt must exist about the effectiveness of an agreement between an underwriter and an issuer in the context of an IPO to modify or displace fiduciary obligations. Considering the absence in underwriting agreements of any term relating to the financial advisory dimension of the relationship, it is arguable that any fiduciary relationship arises independently of the underwriting agreement.

Secondly, since the underwriting agreement is often executed only after the underwriter's advisory role has commenced and, in many cases, after much work has been performed by the underwriter,[123] the underwriter may be subject to fiduciary constraints in negotiating the terms of the agreement.[124] This is not to suggest that fiduciary relations arise before the underwriter–client relation forms, but simply that fiduciary obligations may pre-exist execution of the underwriting

[120] *Ibid*, 178.
[121] *Ibid*, 182.
[122] See Tuch, *supra* n 93, 505.
[123] See Section B3 *supra*.
[124] My thanks to Deborah DeMott for drawing to my attention this issue and the United States legal position described below.

agreement.[125] It is thus conceivable that the underwriter would breach its duty to avoid conflicts by failing to fully disclose and obtain the issuer's consent to any conflicts that it faced at the time of negotiating the underwriting agreement.

Thirdly, parties may not in fact choose to contract around fiduciary obligations. Indeed, outside the US no widespread practice of doing this appears to have emerged.

Finally, it is valuable for commercial parties to know whether fiduciary obligations would arise in the absence of contractual variation or displacement in order to know their "default" position and the utility to be gained from changing their current practice.

D. Consideration of Whether Relationship between Underwriters and Underwriting Clients is Fiduciary in Nature

1. Limitation of Analysis

The analysis in this article necessarily involves attributing fiduciary character to a category of relationship—that between an underwriter and its client in an IPO—rather than to a relationship between particular, identified parties. The claim in this article is that underwriting an IPO should be recognised as a situation where fiduciary obligations will likely arise on an *ad hoc* basis, not that this relationship is a category where fiduciary obligations will always arise. A limitation of this analysis is that the category cannot be described with the same degree of precision as can a specific relationship. However, this limitation is reduced if it is accepted that the relationship between underwriters and their clients is well established and stable enough across firms and clients so as to be capable of description with sufficient precision to enable an informed assessment of its fiduciary character. Section B, which outlined the standardised process of securities underwriting, supports this contention. It follows that, except for the individual transaction that departs from this process, it is possible to draw

[125] It is interesting to note that in the case of the lawyer–client relationship, under United States law, where the contract between the parties is entered into "beyond a reasonable time after the [fiduciary] has begun to represent the client in the matter"—as may be the case in the underwriting relationship—the lawyer has the burden of showing that the terms of the contract and the circumstances of its making are "fair and reasonable to the client" (see *Restatement (Third) of The Law Governing Lawyers* §18(1) (2000)). One rationale for this heightened standard is that "[a] client might accept such a contract because it is burdensome to change lawyers during a representation" or "might hesitate to resist or even to suggest changes in new terms proposed by the lawyer, fearing the lawyer's resentment or believing that the proposals are meant to promote the client's good" (*ibid*, comment *e*). Such concerns are warranted in the underwriting context since a delay in executing the agreement has been suggested to give the underwriter "psychological clout" over the issuer, which is "usually very eager to have the securities underwritten": L Nichols, "The Integrated Disclosure System and its Impact upon Underwriters' Due Diligence: Will Investors be Protected?" (1983) 11 *Securities Regulation Law Journal* 3, 12.

analogies from recognised fiduciary relationships to this one and to determine the presence or absence of the features identified in the relevant cases as giving rise to fiduciary obligations.

2. Existence of Fiduciary Relationship

If the relationship is fiduciary in character, any resulting fiduciary obligations will be owed by the firm (or relevant entity in a group of companies[126]), being an incorporated entity, rather than by individual bankers or other employees.[127]

(a) Previous Cases and Established Relationships

In view of the multifarious roles of the underwriter—involving giving financial advice, providing marketing services, assuming risk and verifying information—there are no close analogies with established fiduciary relationships. However, the financial advisory function of underwriters, in particular, is analogous to that provided by stockbroking firms, banks and corporate advisers in the cases referred to in Section C. Since stockbroking (or retail brokerage) services are also often provided by investment banks, the analogy, in terms of the identity of the parties, is close. Furthermore, these relationships, like the underwriting one, are vertical in the sense that any fiduciary obligations will be owed in one direction only—to the client.

More significantly, the relationship under consideration entails giving investment or financial advice that corresponds closely to the advice which supported the imposition of fiduciary obligations in the cases above. This advice related to the wisdom or merits of entering into a particular investment and any potential alternatives, to financing and timing considerations, and to documenting and implementing the investment decision. It was strategic advice, and involved exercising judgement and applying financial acumen. In *Aequitas*,[128] a case concerning the relationship between a "merchant bank" and its corporate client, the advice that founded the existence of fiduciary obligations involved the structure of the client, the merits and structure of a securities issue to raise funds, and the relative merits of a number of opportunities for use of those funds. In fact, the adviser was to specifically advise on a proposed securities offering.

As discussed in Section B, from the time of its appointment the underwriter will advise on the merits of an IPO, the company's structure, the design and pricing of its securities, alternative uses of capital raised, conduct and timing of the offering, and anticipated investor demand—advice which corresponds closely to that which gave rise to fiduciary obligations in the cases considered. Moreover,

[126] For the purpose of this analysis, it is assumed that the investment bank and the relevant entity providing underwriting services are one and the same.
[127] For a discussion of the possible accessorial liability of these individuals, see Section D5 *infra*.
[128] *Supra* n 56.

the advice also has the capacity significantly to affect the issuer's interests, and in fact will have a significant bearing on the success of the offering.[129] Similarly, as in the cases considered, it requires the exercise of superior expertise and judgement—possessed by the underwriter by virtue of its vast capital markets experience—and must be tailored to the issuer's individual circumstances and objectives.

Countervailing arguments as to the financial sophistication of issuer clients are unpersuasive. It is sufficient that the issuer may be characterised as vulnerable in the sense that it will lack the expertise and knowledge possessed by the underwriter relevant to a public securities offering. This would be particularly so in the case of a company's IPO, being its first exposure to public capital markets.

More contentious, though, is the effect on the incidence of fiduciary obligations of the underwriter not being contractually engaged by the client to provide financial advisory services. This is a reference to the peculiarity that neither in the underwriting agreement nor in any other contract does the underwriter undertake to advise its clients, however integral to the IPO process this may be. Certainly, if the fiduciary obligations arise by virtue of a reasonable expectation that a party will act in the interests of another, then the absence of such a contractual undertaking poses no barrier to fiduciary obligations arising. But if an undertaking to advise is required, as asserted by the High Court in *Daly v Sydney Stock Exchange*, does the underwriting relationship escape fiduciary characterisation for its absence of any *contractual* undertaking? In *Arklow Investments Ltd v Maclean*[130] the Privy Council recognised that an undertaking may be given "impliedly",[131] even though it found that none existed, and in *Commonwealth Bank of Australia v Smith*, where fiduciary obligations did arise, no contractual undertaking was present. Scholars agree that no contractual undertaking is required for fiduciary characterisation.[132] An answer in the negative would also be supported by the decision in *EBC I*, in which the court majority acknowledged that the financial advisory relationship in this context may arise independently of the underwriting agreement. Accordingly, the absence of a contractual undertaking to advise cannot be fatal to the existence of fiduciary obligations.

To deny the existence of an undertaking to advise in the context of an IPO—a transaction in which the provision of financial advice is necessarily a core aspect of the underwriter's role—would be to strain credulity. The real question is the point at which the undertaking is made—and at which the

[129] See Geisst, *supra* n 2, 65, 66.
[130] [2000] 1 WLR 594.
[131] *Ibid*, 600.
[132] See PD Finn, *Fiduciary Obligations* (Sydney, Law Book Co, 1977), [467] and LS Sealy, "Fiduciary Relationships" [1962] *Cambridge Law Journal* 69, 76.

fiduciary relationship arises. This is more difficult to identify. Certainly from the time the underwriting agreement is executed the undertaking would exist. More likely, but again depending on the circumstances, it would be given at the outset of the relationship, being at around the time the engagement letter is executed. From this time—as the next section explains—the close relationship described in Section B above, involving the underwriter providing financial advice and the issuer disclosing confidential information and reposing trust, would give rise to a reasonable or justifiable expectation by the issuer of loyalty from the underwriter. A significant consequence of this is that the underwriter would be subject to fiduciary constraints at the time of negotiating the underwriting agreement.

(b) Reasonable Expectations and Policy Justification

Powerful reasons exist for a client to expect loyalty from the underwriter in providing financial advice. First, the context is significant: access to capital markets is a matter of the greatest strategic significance to a company, and its IPO will be its most important step—increasing its public profile and exposing it to heavy compliance and reporting requirements. Secondly, during the process the company will divulge to the underwriter confidential and sensitive information about its strategic direction, vulnerabilities and other matters for the purposes of receiving financial advice and allowing the underwriter to conduct due diligence. The issuer will be vulnerable to misuse of that information. Thirdly, the advice itself—regarding the structure, terms and timing of the offering, price of securities and proposed uses of funds—are matters of central importance to the success or otherwise of an offering from a business perspective. Related to this is that the imbalance in expertise and knowledge between the underwriter and the issuer makes it likely, if not inevitable, that the issuer's management will depend heavily on this advice. Finally, the underwriter's remuneration structure, which rewards it in direct proportion to the offering proceeds raised, aligns its interests with those of the issuer—a point acknowledged by the court in *EBC I*.[133]

The factors identified by Richard Nolan also justify the existence of a reasonable expectation of loyalty by the issuer.[134] First, the nature of the underwriter's financial advisory role means that it can be performed in any one of a number of unobjectionable ways. This makes it impracticable *ex ante* for the issuer to stipulate with clarity (or for the law to imply) specific constraints on the underwriter's conduct. This may explain why underwriting agreements typically make no mention of the underwriter's financial advisory role. Secondly, the underwriter's task involves the exercise of judgement and application of financial expertise, which are attributes that issuers will lack relative to the underwriter,

[133] See *supra* n 96, 176.
[134] See Nolan, *supra* n 72.

making it difficult *ex post* for issuers to assess an underwriter's performance. Nolan asserts that, for reasons of efficiency and practicality, the law responds in these circumstances by imposing an obligation of loyalty, which is expressed in proscriptive terms.[135] For the present purpose, however, it is contended that these circumstances help to explain why an issuer can reasonably expect loyalty from an underwriter.

Public policy considerations also support such an expectation. First, in an IPO the underwriter acts as gatekeeper—a public-regarding function that involves it verifying information through the due diligence process.[136] To permit it to act in self-interest or third-party interest in such a transaction would be to damage community confidence in the integrity and utility of the role and in capital markets generally. Secondly, the client who is assured of fiduciary protection would be encouraged to disclose confidential information openly and candidly to its underwriter, which is essential for effective securities underwriting.

A compelling case thus exists for regarding the financial advisory aspect of the underwriting relationship as giving rise to fiduciary obligations. It may also be said, based on the normative proposition that a fiduciary relationship should exist where the reasonable expectations criterion is satisfied, that fiduciary obligations in this context *should* be owed.

3. Parameters of Fiduciary Obligations

To characterise the underwriter–issuer interaction as fiduciary does not, however, fully describe the relationship. The content and scope also remain to be defined, as do aspects of it that are governed by statute, common-law principles or other (non-fiduciary) equitable principles.[137]

(a) Content and Scope

The question here is whether, in the absence of contractual modification, equity will impose on an underwriter the duty to avoid positions that conflict with the interests of its underwriting client. Fiduciary obligations are proscriptive in nature—prohibiting fiduciary conduct rather than compelling it—for the purpose of exacting from the fiduciary, in this case the underwriter, a standard of undivided loyalty.[138] Although different types of fiduciary relationships give rise to different fiduciary obligations,[139] twin obligations will ordinarily arise: without

[135] *Ibid*, 423.
[136] See *supra* n 39.
[137] See Meagher et al, *supra* n 56, [5.01]; *Securities and Exchange Commission v Chenery Corporation* (1943) 318 US 80, 85–86.
[138] See *Breen v Williams*, *supra* n 71; *Bristol & West Building Society*, *supra* n 57, 711–12, *Maguire v Makaronis*, *supra* n 71; *Beach Petroleum*, *supra* n 71, 46–47.
[139] *Re Coomber* [1911] 1 Ch 723, 729; *Henderson v Merrett Syndicates Ltd* [1995] 2 AC 145, 206. See also Millett, *supra* n 59, 218–19.

fully informed consent, the fiduciary must avoid conflicts of interest and must not obtain any unauthorised profit from the fiduciary relationship.[140] Breach of either obligation exposes the fiduciary to equity's gain-stripping remedies, which are considered further below. The focus of this article is on the former obligation, although it does encompass much of the latter.[141]

The obligation to avoid positions of conflict prohibits a fiduciary from putting itself in a position where its duty conflicts with self-interest or a duty, legal or equitable, owed to a third party. The rigorous application of the doctrine is reflected in it prohibiting the fiduciary from occupying positions in which there is a "real or substantial possibility of conflict"[142] and in the principle that the honesty of the fiduciary does not provide a complete defence to a fiduciary charged with dereliction of his or her duty.[143] But carelessness, of itself, by an underwriter in giving financial advice will not be a breach of fiduciary duty.

It follows from the above analysis of cases such as *Aequitas* and *Commonwealth Bank of Australia v Smith* (in which fiduciary relationships arose in circumstances where financial, investment, or corporate advice was given) that the duty to avoid conflicts would be owed by the fiduciary within the scope of the relationship.[144] At the same time, the financial advisory function is just one of many functions performed by the underwriter and cannot be regarded as distinct or independent of other aspects of the underwriter's relationship with its client. In fact, in practical terms, the giving of financial advice pervades all aspects of the capital raising process, with the result that the scope of the obligation to avoid conflicts cannot be delimited by reference to the financial advisory dimension. Correspondingly, while the financial advisory role provides a basis for attributing fiduciary character to the underwriting relationship generally, it is submitted that the obligation to avoid conflicts would apply to the extent of the relationship.

[140] *Breen v Williams*, *supra* n 71, 113, 137–38.

[141] This is because a person who makes an unauthorised profit from his or her fiduciary position has usually, but not always, placed self-interest ahead of the interest of the person to whom the duty is owed and thereby also breached the duty to avoid conflicts. See *Boardman v Phipps* [1967] 2 AC 46, 123 (Lord Upjohn). See also RP Austin, "Fiduciary Accountability for Business Opportunities", in PD Finn (ed), *Equity and Commercial Relationships* (Sydney, Law Book Co, 1987), 141, 146; GE Dal Pont, "Conflicts of Interest: The Interplay Between Fiduciary and Confidentiality Law" [2002] *Australian Mining and Petroleum Law Association Yearbook* 583, 584.

[142] See *Pilmer*, *supra* n 64, 199 (McHugh, Gummow, Hayne and Callinan JJ), citing *Hospital Products*, *supra* n 56, 103 (Mason J).

[143] See T Youdan, "The Fiduciary Principle: The Applicability of Proprietary Remedies", in Youdan, *supra* 61, 94. For the case against the traditionally rigid application of the conflict avoidance rule, see JH Langbein "Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?" (2004) 114 *Yale Law Journal* 929.

[144] As to the possibility that courts will mould fiduciary obligations according to the organisational nature of investment banks, see Tuch, *supra* n 93, 509–12.

(b) Overlap with Duty to Protect Confidential Information

In many cases an alternative to an action for breach of fiduciary duty will be an action for breach of the duty to protect confidential information. [145] The duty to protect confidential information prohibits persons who receive information of a confidential nature in what the law regards as circumstances of confidence from making unauthorised use of that information.[146] The relationship between an underwriter and its underwriting client is a situation where this duty arises.[147] The underlying rationale for both duties is the same—namely, to intervene in cases of breaches of trust and confidence.[148]

As there are significant differences between the doctrines, the inquiry in this article has practical significance. To make out a case in equity for protection of confidential information, there must be "actual or threatened misuse of that information";[149] in comparison, fiduciary principles may apply where there is no misuse of confidential information[150] and, further, a misuse of confidential information may occur where the parties do not stand in a fiduciary relationship, provided that the information is communicated in such circumstances as to import an obligation of confidence.

Another difference between the doctrines relates to the effect on each of ethical walls. In respect of actions for breach of the duty to avoid conflicts, the use of ethical walls by investment banks will not always protect a fiduciary.[151] In the case of confidential information, however, the use of ethical walls and other measures such as undertakings can be effective to prevent what would otherwise be a breach of confidence. Recent cases (in the context of law firms and close analogues) in Australia indicate that courts are now more prepared to accept the potential effectiveness of these measures.[152] The wall will be effective where it eliminates any real risk of disclosure of confidential information.[153] This

[145] Glover, *supra* n 56, [4.58], [6.6–6.17]; and see, eg *United Pan-Europe Communications NV v Deutsche Bank AG* [2000] 2 BCLC 461.

[146] Glover, *supra* n 56, [6.10].

[147] This would appear to be implicit in the reasons of Lehane J in *Hadid*, *supra* n 98.

[148] Parkinson, *supra* n 56, [207], [1016].

[149] *Corrs Pavey Whiting & Bryne v Collective Customers* (1987) 14 FCR 434, (Gummow J).

[150] *Oceanic Life Ltd v HIH Casualty & General Insurance Ltd* [1999] NSWSC 292, [44].

[151] The view of the UK Law Commission is that, as a matter of law, ethical or Chinese walls do not afford the type of protection that is needed for a firm to carry on its functions with the degree of assurance that the wall is intended to provide: Law Commission, *supra* n 5, [2.16], [7.15].

[152] See, eg *PhotoCure ASA v Queen's University at Kingston* [2002] FCA 905, [61]; *Bureau Interprofessionnel Des Vins De Bourgogne v Red Earth Nominees Pty Ltd (t/as Taltarni Vineyards)* [2002] FCA 588; PG Willis, "Chinese Walls: Myth Metaphor and Reality — Living with Fiduciary Duties in Resource Relations" (2002) *Australian Mining and Petroleum Law Association Yearbook,* 558, 579–81.

[153] A court will intervene to protect confidential information unless it is satisfied that there is no real risk of disclosure of that information: *Prince Jefri Bolkiah*, *supra* n 109, 237. Information barriers will be effective provided the court is satisfied on the basis of clear and convincing evidence that all effective measures have been taken to ensure that no disclosure of the confidential information

apparent difference in the effectiveness of ethical walls under the doctrines takes on greater importance in the context of investment banks where their use is widespread.[154]

Less stringent remedies are traditionally available against defaulting recipients of confidential information than against defaulting fiduciaries.[155] Also, fiduciary law requirements are increasingly imported into tests of whether a confidence should be protected and the two obligations are often conflated,[156] highlighting the importance of determining whether a particular relationship is fiduciary in character.

(c) Termination of Obligation to Avoid Conflicts

By analogy with the fiduciary relationship between a solicitor and his or her client, the fiduciary relationship between an underwriter and an issuer would end when the relationship ends—at the conclusion of the securities offering.[157] The fiduciary obligation to avoid conflicts of interest would also end at this point, subject to the possible continuation (in Australia only, it seems) of a "duty of loyalty", the content of which is still being developed judicially.[158] Correspondingly, positions of conflict arise in the context of existing (rather than former) clients of investment banks. In the case of former clients, the duty to protect confidential information is the more appropriate basis for any court intervention.[159]

4. Taxonomy of Conflicts of Interest

The full range and character of conflicts of interest in the investment banking industry requires further analysis. For present purposes, however, positions of

will occur: at 237–8. This analysis has been embraced in Australia: see, eg *Newman v Phillips Fox* (1999) 21 WAR 309, 315 (Steytler J); *Bureau Interprofessionnel Des Vins De Bourgogne v Red Earth Nominees Pty Ltd (t/as Taltarni Vineyards)* [2002] FCA 588.

[154] A survey by UK Law Commission of England and Wales indicated that ethical or Chinese walls are very widely used in organisations offering financial services: Law Commission, *supra* n 5, [4.5].

[155] Glover, *supra* n 56, 309.

[156] *Ibid.*

[157] *Prince Jefri Bolkiah*, *supra* n 109, 235.

[158] Some Australian courts have asserted that a duty of loyalty survives the termination of the retainer: see *Spincode Pty Ltd v Look Software Pty Ltd* (2001) 4 VR 501 and *Wadgy Hanna & Associates Pty Ltd v National Library of Australia* [2004] ACTSC 75, [31]–[42]; cf, *Pilmer*, *supra* n 64, 200–1. Furthermore, a breach of fiduciary duty may survive termination of the fiduciary relationship to avoid a fiduciary terminating a fiduciary relationship for the purpose of exploiting opportunities of which he or she becomes aware while acting in a fiduciary capacity: *Furs v Tomkies* (1936) 54 CLR 583, 592; Glover, *supra* n 56, [6.18].

[159] In the case of solicitors, and by analogy the relationship between investment banks and their underwriting clients, the duty to protect any confidential information obtained during the course of an engagement continues after the retainer or engagement has ended: *Prince Jefri Bolkiah*, *supra* n 109, 235.

conflict involving an investment bank's securities underwriting operations may be classified in one of three ways.[160] First, the investment bank's self-interest may conflict with that of its underwriting client—a particular concern in view of the growing importance to investment banks of proprietary trading and principal investing activities. Examples of such conflicts include where an investment bank does any of the following: while advising an issuer on its IPO, considers purchasing that company through its private equity operations, whether as part of a consortium or otherwise, or lending funds to another entity proposing to acquire the issuer; advises on the IPO of a company to which it has previously loaned money in circumstances where the capital raised in the IPO is intended to be used by the company to reduce the loan;[161] or uses information derived in the course, or resulting from the position, of being a fiduciary for its own trading position.

Secondly, a firm may be in a position where the interests of one client conflict with those of another. Conflicts arise where an underwriter undertakes to provide financial advisory services or lend money to another company proposing to take over its current underwriting client. The *EBC I* decision describes the practice of underwriters secretly agreeing with favoured clients to allocate to them "hot" (that is, underpriced) securities issues in exchange for "kickbacks", being payments or other consideration.[162] The "kickbacks" were in addition to the underwriting commission earned on the transaction and were calculated on the basis of the profit made by the customer from the increase in price of the security after it began trading.

Thirdly, conflicts may arise among functions or services provided by an investment bank such that there is a systemic incompatibility with the interests being served. A recent industry-wide example of this concerns the securities trading (or brokerage) services of investment banks, part of whose role is to provide timely, "independent" and unbiased information about public companies to individual investors. This is done by the provision of "research reports". Since the firms also provide—or desire to provide—underwriting services to these companies, they often are in positions where the interests of

[160] I am grateful to Professor DeMott for suggesting a classification for positions of conflicts of interest that investment banks may face, which has formed the basis of the discussion in the text accompanying this note.

[161] A conflict will be more pronounced in this context where the bank's loan exposure is considered poor quality. My thanks to Professor Watts for pointing out, on the basis of Knox J's comments in *Cowan de Groot Properties Ltd v Eagle Trust plc* [1991] BCLC 1045, 1116, that where an underwriter advises a company to which it has previously loaned money, without more, difficulties arise with asserting the existence of a position of conflict for purposes of equitable doctrine.

[162] *EBC I*, *supra* n 96.

recipients of the research reports (individual investors) diverge from the interests of the underwriting clients.[163]

5. Remedial Consequences of Breach

Under the distinctive remedial regime that breach of fiduciary obligation attracts, the fiduciary must account for any profits or make good any losses arising from the breach.[164] Other remedies include a decree that benefits are held on constructive trust for the party to whom the duty was owed[165] and the grant of an injunction to restrain the breach.[166] For an investment bank, being enjoined from acting on a transaction or accounting for its fees would be severely damaging to its reputation.

In the case of breach of fiduciary obligation by an underwriter, the scope of liability may also include the individual bankers and other employees of the firm. These individuals may be exposed to liability—and so be subject to the equitable remedies that are available against the fiduciary—where they induce or assist in the breach of obligation by the fiduciary.[167] This accessorial liability of the individual may arise even though he or she owed no fiduciary obligation to the client and even where the fiduciary is an incorporated entity.[168] Admittedly, judicial views have diverged on the touchstone of liability, namely whether dishonest assistance or knowing assistance by the individual is required.[169] It is tolerably clear, however, that the active and knowing participation by an individual banker or other employee in the breach by the investment bank of its fiduciary obligation would expose him or her to accessorial liability.[170]

[163] In the UK see, eg Financial Services Authority, *Investment Research: Conflicts and Other Issues*, Discussion Essay 15 (July 2002), 15–16. In these circumstances, firms are alleged to have allowed the interests of financial advisory clients to influence the content of published research reports.

[164] See *Tang Man Sit v Capacious Investments* [1996] 1 All ER 193; *Warman International Ltd v Dwyer* (1995) 182 CLR 544.

[165] See, eg *Timber Engineering Co Pty Ltd v Anderson* [1980] 2 NSWLR 488.

[166] See, eg *Marks and Spencer Group plc v Freshfields Bruckhaus Deringer* (unreported, 3 June 2004), CA (Civ Div).

[167] See *Barnes v Addy* (1874) 9 Ch App 244, 251 (Lord Selborne LC); *Consul Developments Pty Ltd v DPC Estates Pty Ltd* (1975) 132 CLR 373; *Australian Securities Commission*, *supra* n 59, 523; *Royal Brunei Airlines Sdn Bhd v Tan Kok Ming* [1995] 2 AC 378; GE Dal Pont and DRC Chalmers, *Equity and Trusts in Australia and New Zealand* (Sydney, LBC Information Series, 2nd edn, 2000), 971–73.

[168] *Royal Brunei Airlines*, *ibid*, 389–92.

[169] The more recent view appears to be that dishonesty, objectively determined, is required. See *Royal Brunei Airlines*, *supra* n 167, 389–92; *Hancock v Porteous* (1999) 32 ACSR 124, 141–42; Dal Pont and Chalmers, *supra* n 167, 971. See also, for support of the requirement of "knowing assistance", *Consul Developments*, *supra* n 167; Glover, *supra* n 56, [8.14]–[8.18]. As to the uncertainty that exists on the appropriate touchstone of liability, see *Australian Securities Commission*, *supra* n 59, 523 (Finn J).

[170] See *Consul Developments*, *supra* n 167, 397 (Gibbs J).

E. Consequences of Existence of Obligation to Avoid Conflicts

1. Practical Consequences

Profound practical difficulties arise since the business of these firms—as providers of a broad and diverse range of products and services to customers, often in different capacities—makes conflicts of interest inevitable.[171] Investment banks commonly institute structural techniques, such as ethical walls, in response to these challenges.[172] However, as a matter of legal principle, there can be no assurance that these measures will be effective in preventing a breach of the duty to avoid conflicts,[173] as demonstrated by the recent action by the Australian Securities and Investments Commission against an investment bank for breach of a duty to avoid conflict of interest.[174] Moreover, concern exists as to the practical adequacy of these measures since they are said to be porous in reality and an appealing but ineffective answer to the problem of conflicts.[175] Thus, the imposition of the obligation to avoid conflicts suggests a potential incompatibility between the traditional financial advisory role of investment banks and their organisational nature.

2. Regulatory Consequences

Difficult questions arise regarding the potential mismatch between regulatory obligations of underwriters and the imposition of the fiduciary duty to avoid conflicts.[176] This mismatch or inconsistency between regulation and fiduciary obligation arises because the regulatory regime operates in addition to the fiduciary obligation; it does not displace it. A direct conflict between these requirements will occur when the regulatory requirement may be discharged by structural measures such as ethical walls, which would not also discharge the fiduciary obligation. It follows that compliance merely with the regulatory requirements may well leave an investment bank in breach of the fiduciary obligation. More significantly, it might reasonably be concluded that the conduct of an investment bank that discharges its regulatory requirements, even if not meeting its fiduciary obligation, is immune from sanction. In the context under consideration, for example, an investment bank might be in a position of conflict

[171] See *supra* n 5.
[172] Law Commission, *supra* n 5, [4.5].
[173] See *supra* n 151.
[174] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd* NSD 651/2006 (Federal Court of Australia). See also V Marsh "Australian Regulator Attacks Citigroup", *Financial Times*, 1 April 2006, 15.
[175] JE Fisch and HA Sale, "The Securities Analyst as Agent: Rethinking the Regulation of Analysts" (2003) 88 *Iowa Law Review* 1035, 1095.
[176] See, eg Law Commission, *supra* n 5; Law Commission, United Kingdom, *Fiduciary Duties and Regulatory Rules*, Report No 236 (London, 1995).

with its underwriting client, but have in place measures, such as information barriers, to manage that position. In this case, the regulatory requirements might be thought to assume the legitimacy of conduct (without actually sanctioning it) that would arguably be a breach of fiduciary obligation.[177] In Australia, the introduction of a new regulatory regime in 2005 without express regard for its apparent mismatch with fiduciary obligation has produced regulatory uncertainty for investment banks.[178]

3. Investment Bank Responses

A number of responses are open to underwriters for dealing with these issues. The most obvious are to obtain the client's informed consent or decline an underwriting engagement where it would place the underwriter in a position of conflict. However, not all conflicts are apparent, and powerful commercial incentives operate against firms declining underwriting engagements due to their lucrative and highly visible nature. Another possibility is for investment banks to rationalise the range of products and services they offer in order to minimise the risk of conflicts arising. This would involve de-merging or spinning off business units. This would reverse investment banks' romance with gigantism which has seen them evolve into full-service financial services conglomerates. While a number of investment banks have begun pursuing this alternative,[179] it is unlikely to hold widespread appeal.

The more likely response is for firms to adopt the contractual techniques to displace or modify fiduciary obligations. This would require firms to alter their engagement letters and underwriting agreements. It would also be advisable for them to provide contractually for the financial advisory dimension of the relationship in order to counteract the view, which was considered persuasive in *EBC I*, that the advisory relationship arises independently of contract.

F. Conclusion

This article has examined the fiduciary nature of the relationship between underwriters and issuing companies in the context of an IPO, a question not previously considered under Anglo-Australian law. It concludes that the financial advisory dimension of the relationship is fiduciary in character, such that underwriters are obliged to avoid positions of conflict while advising on these transactions. This conclusion has profound consequences in an industry riven

[177] These problems are identified in the same terms by the Law Commission, *supra* n 5, [1.13].
[178] See Tuch, *supra* n 4; A Tuch "Guidance Must Come from Regulator", *Australian Financial Review*, 6 April 2006, 63.
[179] See *supra* n 8.

with conflicts of interest. The article has discussed the implications for how firms respond to conflicts, including the use of contractual and structural techniques, as well as the potential mismatch between the fiduciary obligation and regulatory requirements. The analysis underscores the continued significance of the fiduciary question in commercial transactions, the threat it poses to the powerful commercial imperative to accept underwriting and other instructions in the face of conflicts, and the challenge that the traditional financial advisory role of the investment bank presents to the conglomerate investment banking business model.