Syndication for Property Development

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1. Context of Syndication

1.1 The fundraising issues around property development are one of the developer's main hurdles. It can facilitate the deal or, unfortunately all too often, terminate the deal.

1.2 One way property developers can access funding for developments is to syndicate with various investors. In most cases this does not remove the need for bank funding, but provides the initial capital to commence. From this base bank funding will later be used to progress the development.

1.3 The investors are afforded the opportunity to participate in developments otherwise beyond their financial capacity.

1.4 This paper considers the structuring and disclosure issues surrounding syndicating for property development. It does so based on a hypothetical client situation. For reasons that follow, the structure will take the form of a unit trust with a corporate trustee.

1.5 The clients intend to establish a unit trust (the '**Trust**') of which Trustee Co Pty Ltd (the '**Trustee**') will be trustee.

1.6 The Trustee will purchase the property (the '**Property**') that will be developed with the construction of a 50-lot apartment building (the '**Development**').

1.7 The Trust will issue 15 units the price of each being either $400,000. This will provide either $6,000,000, respectively, in equity within the Trust. The Trustee will then obtain Bank funding of $12,000,000. The total $18,000,000 will pay for the purchase of the Property, the construction of the Development and associated costs such as professional fees and stamp duty.

1.8 The Trust will then either sell the apartments of the Development or rent the apartments for a specified period. Which option is chosen will have significant differences for income tax and GST purposes.[1]

2. The Structure

2.1 The clients have expressed the desire to keep the structure for the Development simple.

2.2 For that reason a unit trust with a corporate trustee is appropriate. The Trust and the Trustee meet this requirement.

3. The Corporations Act

3.1 The various forms of collective investments operated by funds management companies are generally offered to investors by way of some form of offer document. Where the investment is offered to retail investors, extensive mandatory disclosure is provided for by statute: for investment companies this occurs under Chapter 6D of the *Corporations Act* 2001 (Cth) (the '**Act**') and for registered schemes, superannuation entities and investment life insurance products, under Chapter 7 of the Act. Funds

[1] The authors' paper *Tax Implications for Property Developers* considers these issues in greater detail.

management companies offering wholesale investment arrangements may choose to market the arrangement through an information memorandum or other disclosure as appropriate.

3.2 Unless otherwise stated, all legislative references are to the Act.

4. The Nature of the Trust's Offer

4.1 The Trust is offering an interest (via one of its 15 units) in a collective investment that will purchase the Property and undertake the Development. The Act considers this to be a 'financial service'.

4.2 Financial services are specific activities that relate to or concern "financial products", which is defined in Division 4 of Part 7.1 of the Act. The definition consists of a broad, functional definition, which is supplemented by a list of express inclusions (s 764A) and an overriding list of express exclusions (in s 765A and regulations 7.1.05 to 7.1.07H of the *Corporations Regulations* 2001 (Cth) (the '**Regulations**')).

4.3 Expressly included in the definition, by s 764A, are company shares and debentures, interests in registered and unregistered managed investment schemes, derivatives, general insurance and life insurance products, superannuation and retirement savings account interest, deposits with authorised deposit-taking institutions such as banks, government bonds and forward foreign exchange contracts.

4.4 The generic term 'managed investment scheme' is used in the Act to refer to a variety of structures for the issue of collective investment interests other than traditional company securities (such as shares or debentures) or prudentially regulated investments (such as investment life insurance products, bank deposits or superannuation products). Typically, as is the case with the Trust, such schemes are open to passive investors and offer returns on a best-endeavours (rather than capital-backed) basis.

4.5 The definition of 'managed investment scheme' in s 9 of the Act is framed in functional and purposive terms. It defines a management investment scheme by what it does, rather than what it is. In other words, in deciding whether something is a managed investment scheme, the definition requires us to look to the purpose for which the arrangement is entered into, rather than the legal form that it adopts. It provides:

"managed investment scheme " means:

(a) a scheme that has the following features:

(i) people contribute money or money's worth as consideration to acquire rights (***interests***) to benefits produced by the scheme (whether the rights are actual, prospective or contingent and whether they are enforceable or not);

(ii) any of the contributions are to be pooled, or used in a common enterprise, to produce financial benefits, or benefits consisting of rights or interests in property, for the people (the ***members***) who hold interests in the scheme (whether as contributors to the scheme or as people who have acquired interests from holders);

(iii) the members do not have day-to-day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions); or

(b) a time-sharing scheme;

but does not include the following:

(c) a partnership that has more than 20 members but does not need to be incorporated or formed under an Australian law because of regulations made for the purposes of subsection 115(2);

Note: This paragraph has an extended meaning in relation to Chapter 8 (see subsection 1200A(3)).

(d) a body corporate (other than a body corporate that operates as a time sharing scheme);

(e) a scheme in which all the members are bodies corporate that are related to each other and to the body corporate that promotes the scheme;

(f) a franchise;

(g) a statutory fund maintained under the *Life Insurance Act 1995* ;

(h) a regulated superannuation fund, an approved deposit fund, a pooled superannuation trust, or a public sector superannuation scheme, within the meaning of the *Superannuation Industry (Supervision) Act 1993 z*;

(i) a scheme operated by an Australian ADI in the ordinary course of its banking business;

Note: This paragraph has an extended meaning in relation to Chapter 8 (see subsection 1200A(3)).

(j) the issue of debentures or convertible notes by a body corporate;

(k) a barter scheme under which each participant may obtain goods or services from another participant for consideration that is wholly or substantially in kind rather than in cash;

(l) a retirement village scheme operating within or outside Australia:

(i) under which the participants, or a majority of them, are provided, or are to be provided, with residential accommodation within a retirement village (whether or not the entitlement of a participant to be provided with accommodation derives from a proprietary interest held by the participant in the premises where the accommodation is, or is to be, provided); and

(ii) which is not a time-sharing scheme;

(m) a scheme that is operated by a co-operative company registered under Part VI of the *Companies (Co-operative) Act 1943* of Western Australia or under a previous law of Western Australia that corresponds to that Part;

(ma) a contribution plan;

(n) a scheme of a kind declared by the regulations not to be a managed investment scheme.

Note: Paragraph (c)--A partnership with less than 20 members will usually not require registration because of paragraph 601ED(1)(a) and under section 115 a partnership with more than 20 members can only operate if covered by regulations made for the purposes of subsection 115(2).

4.6 Most managed investments schemes – again, as is the case with the Trust – often take the legal form of a unit trust. In a unit trust, investors hand over money or assets to a professional manager who manages the total fund or collection of assets to produce a return that is shared by the investors: see the joint report of the ALRC / CAMAC, *ALRC 65* (1993) at [1.2]. The High Court discussed the nature of a unitholder's interest in *CPT Custodian Pty Ltd v Commissioner of State Revenue; Commissioner of State Revenue v Karingal 2 Holdings Pty Ltd* (2005) 221 ALR 196.

4.7 The Trust is a "managed investment scheme" (s 9) and, therefore, is an interest in a "financial product" (s 764A).

5. Advantages of a Unit Trust Structure

5.1 Unit Trusts are widely utilised in Australia for pooled investment in real property and financial instruments. The attractiveness of the trust as a vehicle for collective investment can be attributed to a combination of legal, commercial and taxation considerations. However, care must be taken to ensure that the scheme is eligible to be treated as unit trust that is not a "public trading trust" for tax purposes, as a public trading trust is liable to be taxed like a company. A unit trust will be a public trading trust if it carries on a trading business, or controls or is able to control, directly or indirectly, a trading business carried on by another person. If the Trust is undertaking the Development and then:

5.1.1 holding the apartments for rental income there is a low risk of the Trust being a public trading trust; and

5.1.2 selling the apartments for profit on sales there is a higher risk f the Trust being a public trading trust, but whether this is so depends on the number of developments those associated with the Trust have undertaken.

5.2 Depending on their particular circumstances, investors may be advantaged by the use of a unit trust (rather than a company or other vehicle) as the vehicle for carrying out an investment activity, because of the commination of:

5.2.1 the flow-through tax treatment applied to trusts;

5.2.2 tax deferral on certain components of the distributions paid by trusts to their investors;

5.2.3 the treatment of franking credits attaching to dividends received by trusts on their investments;

5.2.4 the treatment of capital gains realised by trusts; and

5.2.5 the treatment of capital gains on disposal by an investor of its units in the trust.

5.3 Each investor will need to determine their own tax position in each given financial year.

6. **Registered or Unregistered**

6.1 Managed investment schemes, which the Trust is, are then further subdivided into those that are required to be, and are, registered with ASIC in accordance with Chapter 5C of the Act and those that are not.

6.2 A managed investment scheme must be registered if all of four criteria are met: These criteria are that the scheme:

6.2.1 is a management investment scheme (s 9 of the Act);

6.2.2 satisfied any one of the following three criteria – it has more than 20 members; it was promoted by a person, or an associate of a person, who was, when the scheme was promoted, in the business of promoting managed investment schemes; or it is one of a number of schemes that ASIC has determined are related in accordance with s 601ED(3) of the Act, that between them have more than 20 members (s 601ED(1) of the Act);

6.2.3 has issued interests in circumstances that would have required the giving of a PDS under Division 2 of Part 7.9 of the Act if the scheme had been registered when the issues were made and the division applied to the interests at that time (s 601Ed(2) of the Act and reg 5C.11.05A of the Regulations); and

6.2.4 has not been granted an exemption from registration by ASIC (s 601QA of the Act).

6.3 As there is to be less than 20 investors in the Trust it will not be required to be registered by that fact.

6.4 As to whether a person is in the business of promoting managed investment schemes, see *ASIC v Chase Capital Management Pty Ltd* (2001) 19 ACLC 476 at 486; *ASIC v Young* (2003) 21 ACLC 655, in which Muir J held that:

'*whatever the full scope of the meaning of "promoted" in the subject context, it plainly extends to activities in which a person formulates a scheme such as the [relevant] scheme, advertises it, solicitors others to participate in it and embarks upon its implementation.*

6.5 If it was the first syndication it may be that the Clients are not in the business of promoting management investment schemes. Subsequent syndicates may cause this fact to change.

6.6 As to the third requirement, the effect of Division 2 of Part 7.9 of the Act is that, where interests are offered to potential investors who are "retail clients" within the meaning of s 761G or 761GA of the Act, a Product Disclosure Statement ('**PDS**') must be provided, unless the offer comes within one of the specific exemptions contained in ss 1012D or 1012E of the Act. Section:

6.6.1 1012D contains various general exemptions, including exemptions for offers made to officers of the responsible entity, for distribution reinvestment plans, and for bonus issues.

6.6.2 1012E contains the exemption for personal offers made by an issuer that do not breach the 20 purchasers ceiling or $2 million ceiling for the 12-month period.

6.7 In broad terms, a person is treated as a retail client unless they are a professional investor, large business, high net worth individual or sophisticated investor, or the price for the provision of the interest in the scheme equals or exceeds $500,000.

6.8 If the Clients are considered to be in the business of promoting managed investment schemes the Trust will have to be registered as a managed investment scheme. But, as Pincus J said in *ASC v Woods and Johnson Developments Pty Ltd* (1991) 31 FCR 560:

> *promotion of a single project may be enough to enable the applicant to succeed in a case of this kind [requiring a finding that the promoter was in the business of promotion], but only if that undertaking is the first in a business of promoting similar undertakings.*

6.9 If the Clients are not in that business it will be an unregistered managed investment scheme.

6.10 The operation of a managed investment scheme, that is required to be registered, without registration is prohibited: ss 601ED(5) and 601EE of the Act.

6.11 After the implementation of the *Financial Services Reform Act* (now Chapter 7 of the Act), however, interests in managed investment schemes – whether registered or not – are subject to the requirements of the Act because they are considered a type of financial product: s 764(1)(b)(1) of the Act. In consequence the disclosures discussed at point 7 apply whether it is registered or not.

6.12 Registered schemes are required to produce and provide financial reports to investors on an annual or semi-annual basis, in accordance with Chapter 2M of the Act. They are also subject to the continuous disclosure requirements under Chapter 6CA of the Act.

7. Issue of prospectus or PDS

7.1 The pre-sale disclosure rules for financial products are contained in Part 7.9 of the Act and the corresponding provisions of the Regulations.

7.2 Section 1012B of the Act requires the provision of a PDS in various issue circumstances. Similarly, s 1012C requires the provision of a PDS in numerous sale or offer circumstances. However, s 1012B(3), which concerns offers to issue a financial product, and s 1012C(3), which concerns offers for the sale of a financial product, require that a PDS be given only if the issue or sale, as applicable, of the product is to a person that is a retail client.

7.3 Section 761G(7) of the Act states that a financial product, such as an interest in a managed investment scheme, is not provided to a person as a retail client if:

7.3.1 the price for, or value of, the product exceeds an amount prescribed by the regulations (currently, $500,000 – regs 7.1.18 and 7.1.19 of the Regulations);

7.3.2 the product is provided for use in connection with a business which is not a small business ("small business" is defined in s 761G(2) of the Act as a business which manufactures goods and employs less than 100 people or any other business which employs less than 20 people);

7.3.3 the financial product is provided to a person with net assets of $2.5 million or income in each of the last two financial years of $250,000 per annum (reg 7.1.28 of the Regulations); or

7.3.4 the person is a professional investor (see s 9 of the Act).

7.4 As there are retail clients, the Trust will therefore require the issue of a PDS unless the units are priced over $500,000.

7.5 Part 7.9 of the Act prescribes the disclosure requirements for a PDS. The primary disclosure requirements are contains in s 1013D, which contains a general disclosure test. It requires the following:

7.5.1 name and contact details of the issuer or seller;

7.5.2 information about any significant benefits to which the holder of the product may be entitled, the circumstances of entitlement and the way that they will be provided;

7.5.3 any significant risks associated with holding the products;

7.5.4 information about the cost of the product, amounts to be paid by the holder after acquisition of the product and (if the payment is made into a common fund) any amount to be paid as fees, expenses or charges;

7.5.5 if the product will generate a return to the holder;

7.5.6 information about commissions which will impact upon the returns;

7.5.7 information about other significant characteristics or features of the product (rights, terms, conditions or obligations);

7.5.8 information about any internal and external dispute resolution procedures;

7.5.9 general information about significant tax implications of such products;

7.5.10 information about any cooling-off regime that applies;

7.5.11 a statement as to how further information may be accessed if the issuer or seller makes other information available

7.5.12 other information required by regulation; and

7.5.13 if the product has an investment component, the extent to which labour standards or environmental, social or ethical considerations are taken into account in investment decisions (managed investment products are deemed by s 1013D(2A) to have an investment component).

7.6 For paragraph 7.5.12, reg 7.6.01C requires, where the issuer of the PDS is a finance services licencee, the PDS to contain the licensee's licence number. Also, Class Order 05/26 requires, where relevant, the PDS to state that a pricing discretionary policy or a record of an exercise of a pricing discretion (as provided for in ss 601GAB and 601GAC as inserted by Class Order 05/26) are available from the responsible entity free of charge.

8. Short Form PDS

8.1 Amendments were made to the Regulations by the *Corporations Amendment Regulations* 2005 (No 5) which commenced on 15 December 2005. One of the changes facilitated was the establishment of the Short-Form PDS via the introduction of reg 7.9.61AA(5). This regulation modifies Part 7.9 of the Act in its application to Short-Form PDSs in the manner set out in Schedule 10BA to the Regulations. That schedule sets out the required contents of a Short-Form PDS.

8.2 As the name suggests, a Short-Form PDS is a concise or summary version of a full PDS which a PDS issuer may provide to consumers instead of a PDS. The use of a Short-Form PDS is optional. However, a Short-Form PDS does not replace a full PDS. A preparer of a Short-Form PDs must still prepare a complete PDs and provide it to consumers if requested.

9. Lodgement of the PDS

9.1 There is no general requirement for a PDS to be lodged, but the person responsible for the PDS must inform ASIC that the PDS is in use as soon as practicable, and within five business days, after it is fist given to a person in a recommendation, issuer or sale situation: s 1015D(2) of the Act. A copy of the PDS must be retained for 7 years after the date of the PDS: s 1015D(3) of the Act.

10. The legal nature of representations and promises made in a prospectus of PDS

10.1 The objectives behind the need to provide disclosure documents (whether it be a prospectus or PDS) is investor protection. The disclosure documents are to help investors compare and make informed choices about financial products: PS 168.7. This has resulted in legislative requirements that:

10.1.1 information be worded and presented in a clear, concise and effective manner: s 1013C(3); and

10.1.2 prohibit misleading or deceptive conduct or statements: ss 1041E and 1041H.

10.2 The Act provides remedies to investors where product issuers have failed to meet the obligations that the legislation has placed on them. The remedies available to investors include the right to avoid the contract with the issuer where the product issuer is operating an unregistered managed investment scheme that is required to be registered or where the product issuer does not comply with the PDS requirements in Division 2 of Part 7.9: s 601MB.

10.3 The remedy in s 601MB provides that the contract to subscribe for an interest in a managed investment scheme entered into by the investor as a result of the issuer making an offer or invitation to subscribe for interests, is voidable at the option of the investor by notice in writing to the issuer.

10.4 Where an investor gives such a notice then the obligations of the parties are suspended for 21 days and the contract is voided at the end of the 21 day period: ss 601MB(2) and (3). The issuer may however, within the 21 day period make an application to the Court seeking a declaration that the notice given by the investor to the issuer has no effect: s 601MB(4). Where the Court is satisfied that it is just and equitable to make the declaration then the contract is not avoided: s 601MB(6).

10.5 The provision does not provide any time limit on the investor for giving the notice to avoid the contract. However, the Federal Court of Australia (Von Doussa, Mansfield and Goldberg JJ in *Ellison v Lutre and Anor* 30 ACSR 615) when interpreting s 1073, being the predecessor to s 601MB, held that the right of the investor to avoid a contract with an issuer does not exclude the common law doctrine of election from applying in appropriate circumstances.

10.6 Consequently, the conduct of an investor may be such to constitute an election that the contract be affirmed thereby causing the investor to lose the right to rescind the contract. The act of affirmation may be explicit or may be inferred by conduct. The conduct of the investor may be sufficient to result in an affirmation of the contract even before the investor becomes aware of the legal right to rescind the contract.

10.7 The structure of the legislative regime is not to make the representations in the disclosure document a term of the trust deed or term of the contract entered into by the investor and the issuer. Rather, the promises in the disclosure documents remain representations. Those representations are made, in effect, legally binding by s 601MB and the other remedy provisions.

10.8 The ability to rely on s 601MB to avoid a contract with the issuer is limited to circumstances where the issuer fails to comply with Division 2 of Part 7.9 and not Part 7.9 generally. Consequently the mere fact that a promise has not been kept by the issuer will not necessarily allow an investor to rely on s 601MB. Division 2 mainly deals with the need to give a PDS and its specific contents. If a PDS is given to the investor then Division 2 only places obligations on the issuer or gives rights to the investor within one month of the issue of the interests: see ss 1016E and 1016F.

10.9 Where the promise is not kept after one month of the issue of the interests (and a PDS has been given) then the investors lose the right to rescind the contract with the issuer. The investors then need to rely on the civil liability provision for compensation for loss or damage arising from a defective disclosure document: s 1022B.

10.10 Alternatively, the investors need to rely on ASIC enforcement pursuant to Division 7 of Part 7.9, Division 2 of Part 7.10 and Part 9.4. Further, the investor may be able to benefit from a consequential order made under Part 9.5 if the issuer is liable of an offence under Part 7.10. The orders include the power to compensate the investor for any loss or damage caused by the contravention of Part 7.10 (which includes the making of false or misleading statements: s 1041E): s 1325.

11. Unsolicited invitations to meeting

11.1 There are three provisions in the Act which limit the ability of persons to make unsolicited invitations to prospective investors. Section 736 provides that a person must not offer securities for issue or sale in the course of, or because of, an unsolicited meeting with another person or unsolicited telephone call to another person. The amendments made by the *Financial Services Reform Act* also insert s 992A prohibiting a person offering financial products for issue or sale in the course of, or because of, an unsolicited meeting with another person, and s 992AA prohibiting a person from offering interests in managed investment schemes for issue or sale in the course of, or because of, an unsolicited meeting with another person or an unsolicited telephone call to another person. Each provision has a number of exemptions: s 736(2), ss 992A(2) and (3) and s 992AA(2).

11.2 Section 1442A provided for the possible deferred application of s 992A. However, by Gazette Number GN42, 24 October 2001, Page 3289, it was proclaimed that there would be no deferred application of the hawking provision in s 992A. It is noted that the prohibition in s 992A is the residual provision in that it does not apply to a hawking which is prohibited by s 736 or s 992AA.

11.3 By Class Order CO02/641, ASIC has confirmed that s 992A does not apply to securities or interests in registered or unregistered managed investment schemes. Consequently, whilst it possible to read s 992A(3) applying to the offer of interests in managed investment schemes, the Class Order now means that the hawking prohibitions in relation to managed investment schemes are solely regulated by s 992AA.

11.4 The hawking prohibitions apply only to unsolicited telephone calls and meetings. They do not apply to any other form of unsolicited communication, including emails, letters, brochures or advertisements: Paragraph A1.2 of the Hawking Prohibitions an ASIC Guide.

11.5 A meeting or telephone call will be unsolicited in the view of ASIC unless it takes place in response to a positive, specific and informed request from a prospective investor. A positive request requires the prospective investor making an active step or some conscious decision to have a representative of the Trust or the Clients call the investor to discuss the investment or arrange a meeting. For the investor to have made a specific and informed request it is necessary that the prospective investor know of the nature of the meeting and the type of financial products that are to be discussed.

11.6 Unsolicited meetings or telephone calls can be made to a person who is not a retail client: s 992AA(2)(a). A retail client is defined in s 761G and is any prospective investor other than those specifically listed in paragraphs 761G(7)(a)-(d). As to this see the earlier discussion.

11.7 An offer in a listed managed investment scheme may be made by an unsolicited telephone call made by a financial services licensee: s 992AA(2)(b). There is no indication to say that the Trust is to be listed.

11.8 Finally, an unsolicited meeting or telephone call can be made to a client by a financial services licensee through whom the client has acquired or disposed of an interest in a managed investment scheme in the previous 12 months: s 992AA(2)(c).

12. Discovery of errors in prospectus of PDS

12.1 If an issuer becomes aware that:

12.1.1 the disclosure document contains a misleading and deceptive statement; or

12.1.2 there is an omission of information that should have been included in the disclosure document,

that is materially adverse to a reasonable person trying to decide whether to acquire the financial product then s 1016E of Division 2 of Part 7.9 applies.

12.2 Section 1016E also applies where the issuer becomes aware of new circumstances that:

12.2.1 have arisen since the disclosure document was prepared;

12.2.2 would have been required to be included in the disclosure document; and

12.2.3 is materially adverse to a reasonable person trying to decide whether to acquire the financial product.

12.3 Where s 1016E applies and no interests of that kind have yet been issued then the issuer must:

12.3.1 repay the money invested by the investor;

12.3.2 issue a supplementary PDS and give the investor one month to withdraw the application and be repaid; or

12.3.3 issue the interest with the Supplementary PDS and give the investor one month to return the financial product and be repaid.

12.4 Where s 1016E applies and interests have been issued or sold then the investor has the right to return the product and to have their money repaid: s 1016F. The right to return the financial product must however be exercised during the period of one month starting on the date of issue of the product to the client: s 1016F(4).

12.5 There are no defences to the issuer or the directors of the issuer in respect of the obligation to return investors money pursuant to ss 1016E, 1016F, 718 or 737.

12.6 The failure to comply with s 1016E will also result in the issuer breaching other provisions of Division 7 of Part 7.9 and Division 2 of Part 7.10. The relevant offences in Division 7 of Part 7.9 include:

12.6.1 preparation of defective disclosure document knowing it to be defective: s 1012D. To be guilty of an offence under s 1012D the preparer must be required under Part 7.9 to give the document to a person or must be reckless in giving out or making available (whether directly or indirectly) the disclosure document;

12.6.2 preparation of defective disclosure document whether or not knowing it to be defective: s 1012E;

12.6.3 a regulated person (s 1011B) other than the preparer gives a disclosure document knowing it to be defective: s 1021F;

12.6.4 becoming aware of disclosure document being defective and not taking the required steps as soon as practicable: s 1021J.